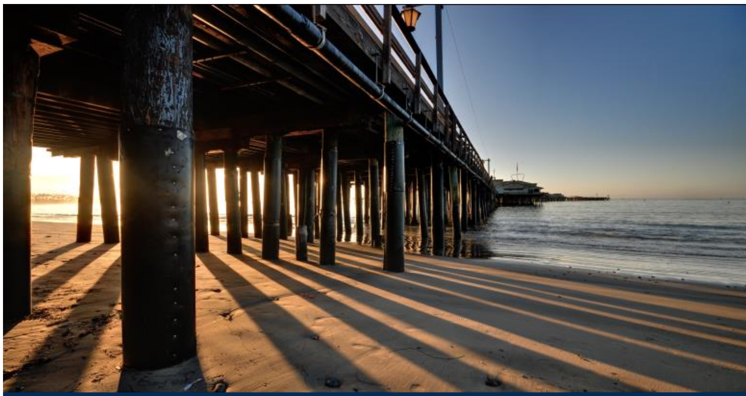

PERITUS
ASSET MANAGEMENT, LLC

Active Credit

August 2014

PERITUS INVESTOR'S MANUAL

At Peritus we run actively managed portfolios of high yield debt. Our primary goal is to provide investors with a high current income, as well as the potential for capital appreciation. In addition to investing in the high yield bond market, we also look to the floating rate loan market and the equity market as we seek to generate this tangible yield for investors. We run truly active portfolios, meaning that the portfolio is diversified (typically 40-100 names) without being "de-worsified." Many managers claim to run "active" portfolios in mutual fund form, yet some hold over 500 securities. To us, this is closet indexing and is not an active process.

In trying to define our strategy, we have searched for the right vernacular and we have come up with the following:

"Corporate credit investing, capital structure agnostic"

Investors who have known us for decades have more simply described the philosophy as "credit investing with all-season tires." Our job is to seek to maximize yield for our investors, while working to mitigate the downside risks within the portfolio.

An Inefficient Asset Class

We believe that the best approach to credit is to not only be agnostic on the capital structure but also on the credit ratings. This ratings agnosticism is central to our investment philosophy and process. We believe that credit ratings have created inefficiencies in corporate credit and an opportunity for those willing to step down on the ratings spectrum. Credit ratings tend to be backward looking algorithms that favor the size and longevity of a business. The reality is that we are lending money to companies today and care about the future. As such, historical ratings are interesting, but we believe not particularly relevant. Think of equities: how many investors consider issuer/credit ratings for a company when they buy its stock? If you are buying the most junior piece of the capital structure and don't consider them, then why is so much emphasis placed on ratings for bond investors?

What I have seen in 30 years is that many investors continue to avoid bonds and loans rated below BBB (the dividing line between investment grade and non-investment grade) which is what creates the first structural inefficiency for the high yield market and can allow us to generate potential alpha. What is mind numbing to me is that we have now gone through two "nuclear winters" (2002 and 2008) and the absurdity of credit ratings were at the core of both. Do you remember what the ratings for Worldcom and Enron were just before they filed for

bankruptcy and set the world on fire? Investment grade! How about the 2008 meltdown? Weren't Moody's and Standard and Poor's at the center of the flame with their AAA ratings on sub-prime Collateralized Debt Obligations (CDOs)? It was so bad that government intervention and even legislation was pursued to remove credit ratings for bank and insurance determined capital ratios. It never happened and all just quietly died. Yet some investors continue to invest by and are beholden to this ratings process, which we view as limiting and potentially misguided.

Once investors migrate below investment grade, there is a further bi-furcation in high yield, as many players pitch what we like to call the "cream of the crap" story. In essence, they will buy only BB rated securities. Again, an investment process that is being dictated by rating agency black boxes. We would argue that a portfolio of BB securities today could quite possibly be the worst of both worlds: you are still exposed to credit risk yet generate minimal yield. Additionally, many BB securities trade like investment grade, meaning they are often very sensitive to changes in interest rates and may have much longer durations given their lower yields.

No diatribe on ratings would be complete without a little chat about investment grade corporate bond markets. Investment grade is defined by Standard and Poor's as BBB- and higher, while Moody's defines it as Baa3 and higher. I have been in the leveraged finance business for 30 years. I cannot tell you the fundamental difference between a BB+ credit and a BBB- credit, yet one is "investment grade" and one is "junk." Who gave these firms the right to determine this and how is it determined? For a much more detailed discussion on this, please see our piece "The New Case for High Yield."

The Peritus Process: Managing Risk

What this all means is that we see continued pricing inefficiencies in single B and CCC credits as most investors avoid them given their perceived "risk." But what is this risk and how is it defined? To us, risk is about losing money and managing risk is what portfolio management is all about. Let's begin with credit risk, which is something we take on and expect to get paid for. First of all, credit investing is a negative art. What you don't buy is more important than what you do buy. Investors will not appreciate this until the cycle turns, which will inevitably happen at some point.

What are we looking to avoid? The common answer is defaults. But this is not entirely accurate. We can make money if a company defaults assuming that the perceived recovery of the bond or loan is higher than what we paid for it. Let me be clear: we are not buying distressed assets in the hope of making money; this type of vulture investing is very specific. We are in fact looking to avoid defaults and losses.

But just how do we seek to avoid defaults, or more accurately seek to avoid losses? Let's look at the negative first. Here is generally what we don't like:

- Companies that use cash and don't generate it.
- Businesses that have a lack of liquidity.
- Enterprises that are highly levered with lack of free cash flow growth.
- A product or service that is non-essential.

- Buying bonds/loans priced well above their call prices (negative convexity).
- Bonds/loans issued for "bad" purposes such as dividends to private equity sponsors.
- Bonds that do not pay cash interest, such as PIKs (pay-in-kind) or PIK toggles.

While this seems pretty straight forward and sensible, it is remarkable to watch these disciplines get thrown out the window in the chase for yield. These errors are glossed over when capital markets are wide open, but get magnified when they close up. On the positive side of the ledger, here is generally what we like:

- Companies that generate true free cash flow (cash flow from operations less normalized capital expenditures).
- Businesses that have excess liquidity in the form of cash and/or bank line availability.
- A company selling a product or service that is considered a consumer essential.
- Recurring/contracted revenue streams.
- Buying debt at discounts to par or call prices.

All of this seems pretty straight forward and much of it is pitched by other value investors. Execution of this (holding one's discipline when everyone else is waving it in) is much tougher to do than to say. More difficult yet is real "alpha" generation, which involves buying undervalued securities to generate excess yield and/or capital gains. Most of what we have said above is related to business fundamentals. That is only the first step in the process. We then have to look at the price of the securities (loans/bonds/equity) that represent the investment. Investing is a non-linear art form. Our job is to ferret out those securities we believe are "mis-priced."

There are a number of reasons securities become mis-priced including, but not limited to, the following:

- General industry unpopularity
- Asset class unpopularity
- Quarterly earnings miss
- Poor forward guidance
- Litigation
- Product or cost pricing issues

Our analysis must determine that whatever factors caused the "mis-pricing" are not serious enough to cause impairment or default and they are temporary. Each business must be analyzed independently and an assessment has to be made of where the best value lies in the capital structure.

This is the common "glue" to the Peritus investment process. Now, how are we working to generate alpha in today's environment?

Thematic Investing

We have historically been a very big thematic investor. Today one theme we are focusing on is the energy markets. But as we stated, great investing is non-linear or a counter-intuitive process.

Contrary to what seems to be a popular trend among investors these days, we are avoiding the U.S. exploration and production companies operating purely in certain geographies of the U.S. shale basins. We believe that they represent two key features on our avoidance list: incredibly popular industries with high prices/low yields and no free cash flow generation or sustainable business model. We do believe that oil prices will stay high (a supply issue) and that natural gas prices are going to be driven much higher (demand issue). However, we believe the primary beneficiary of this is the Western Canadian Sedimentary Basin ('WCSB"), where, unlike in certain U.S. shale markets, the production is long lived and sustainable and pricing is supported by global markets. The distraction provided by the shale "revolution" and the Keystone political debate is allowing us to buy debt and dividend paying equities in the Great White North with what we see as outstanding valuations and attractive yields.

Floating Rate Loan Secondary Issues

The floating rate loan market had experienced weekly inflows for almost two years straight. There has been a recent pause, but the avalanche of cash coming into the market over the last couple of years has been astounding. This has been based on the notion that this asset class benefits from rising rates. We believe there are two major flaws in that argument. First, these loans are "LIBOR" based loans. "LIBOR" is the London Interbank Offering Rate and the 3-month version of that rate actually came down to 0.23% from 0.28% over the past year.[1] So while 10-year Treasury yields rose from 1.78% to 3.04% back in 2013[2], LIBOR actually fell. Secondly, many of these loans come with "floors" meaning that regardless what LIBOR actually is, they have a base rate. This is typically 100-150 (1.00%-1.50%) basis points. This means that LIBOR would have to rise from 0.23% to 1-1.5% (or up to nearly 700%) for investors to get any benefit. I don't believe this will happen. Given the popularity of bank loan products, many companies have chosen to raise money in loan form versus bond form. So we have numerous companies that we want to invest in that trade loans only and not bonds. By having access to the loan market, we have been able to expand our investment opportunity set within corporate credit.

Most importantly, we believe that the story of higher rates is growing tired and that redemptions have begun to come the way of the large mutual funds and ETFs that traffic in this loan asset class will continue to pick up speed. This is important as we do not see a natural buyer for secondary loans, which means we may have an opportunity to extract discounts on future purchases, thereby generating potentially higher yields and capital gains for investors. Collateralized Loan Obligations ("CLOs") are certainly a potential bid but, based on our experience, most of these platforms are often 50-70% ramped (meaning that collateral, or the underlying loans, are already purchased) upon close, so they are not actively buying loans for a large portion of their portfolio post-closing. Furthermore, CLOs are often set up to focus purchases on primary loan deals, as these newly issued loans are frequently offered with an "OID" (original issue discount) and certain players can often get larger allocations. We believe our opportunity is just beginning to be set up in secondary loans.

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[1] Data sourced from www.bankrate.com, as of 6/27/14.

[2] Data sourced from the U.S. Department of the Treasury, "Daily Yield Curve Rates." Ending rates for 12/31/12 versus 12/31/13.

Post Restructurings

While the overall percentage of defaults in the high yield and leveraged loan market remain well under historical norms, there are still defaults happening beneath the surface. Typically, these are poorly structured leveraged buyouts or companies that suffered from an external shock. Upon exit from a Chapter 11 bankruptcy filing (whether pre-packaged/pre-arranged bankruptcy with stakeholders or not) these companies often have much less leverage and more sustainable capital structures. Importantly, they typically have much higher yields than similarly levered capital structures given their recent exit from the penalty box. We believe this is a niche that is likely to grow as capital markets eventually become less forgiving.

Equities, Dividends and Refinancings

Our final category involves the equity market. We have two very specific focuses with our equity investments. The first is related to thematic investing. Though our themes will continue to evolve and change, the equity component in our portfolios are there to help execute on what we call "price to conviction." This means that we may have a very high degree of conviction on our particular theme and, in some cases, want to execute on this concept with the highest rate of return security available, which could be a dividend paying equity. In today's environment it involves our energy theme. We are looking to take advantage of what we feel are sustained high prices for oil and natural gas. Companies operating in the Western Canadian Sedimentary Basin have much different (sustainable) production profiles than many in the shale basins in the US. Several things are important to note: because Canada has a very nascent high yield market, companies often need the equity market to raise capital. As such, many of these companies may pay out significant yields to attract investors and treat their dividends like interest payments. They recognize that their dividend payments are sacrosanct and will adjust capital expenditures rather than cut their dividends. And given the lack of substantial debt in many cases, we see the enterprise value through the equity as attractive.

The second specific equity thematic involves seeking to take advantage of the recent wave of refinancings for high yield companies. We have stated that we are capital structure agnostic. In this case, we have seen a number of companies refinance their bonds some 3.0% cheaper. The interest savings flows down the capital structure to the benefit of the equity. So the dividend is further enhanced/protected by this interest savings and in some cases our determination is the equity becomes the best risk/return part of the capital structure.

Selectivity and forward looking credit analysis is essential in this final category. Many investors have been caught up in the mania of Master Limited Partnership ("MLP") investing. Many have been enticed by juicy yields offered by these companies. Unfortunately many of them are not generating true distributable cash. Worse yet, "cash available for distribution" is a metric that the company themselves calculate. We see this is a situation of the fox guarding the hen house. This metric is calculated by breaking up capital expenditures into "maintenance" and "growth." So the more the company lumps their capital expenditures into the "growth" bucket the more fictional cash flow they have available. Some of the companies we have looked at state that 80% of their capital expenditures are "growth," yet they aren't growing. For investors this then is a return *of* capital not a return *on* capital and is unsustainable.

One final point on the MLP sector. Many companies involved in building out midstream (gathering/processing/transmission) energy infrastructure projects are ill suited for this type of flow through mechanism. They need all the money they can raise to build these projects, not to pay out all of their proceeds to investors. A few of these do make sense given that they are a truly mature business. Active and granular investing in this segment is critical and challenging.

ETF Investing

Looking at the broad investment space and the various investment vehicles offered, we see benefits to investing in ETFs, including the instant liquidity for shareholders (via intra-day trading) and tax efficiency. Today, indexing and ETFs are practically synonymous, as many embrace its ability for broad exposure to the given asset class and ease of trading, but indexing in fixed income is a bit of a misnomer. You cannot actually own all of the bonds in a particular index because unlike stocks, many of the bonds are bought and put away (think liability matching with banks and insurance companies), so are not readily available. Ultimately it means matching the index as closely as possible within certain parameters, which for mortgage, agency, Treasury, and municipal bonds is reasonably effective, but can be decidedly more difficult in the corporate bond market.

We believe that trying to index high yielding credit assets can pose additional risks. The primary risk we are dealing with is credit or default risk. As part of this broad exposure to the asset class, index-based, passive investing, would largely have you indiscriminately buy based upon the underlying index's parameters, creating a portfolio of hundreds of securities and giving you that exposure to the statistics and performance of the asset class. While some might be attracted to this broad exposure, especially those traders who temporarily position themselves for exposure to the asset class based on market technicals, for longer-term investors, we don't see this as the best approach. We instead see indexing or passive investing as akin to a banker standing on the street lending money to every passerby so they could build a very large loan book and would end up with an "average" delinquency or charge off. At the end of the day, we feel that fundamental work can and should be done in order to assess the creditworthiness of the borrower (i.e. the bond issuer). We believe that active management is essential in this asset class as managers can undertake this credit selection and seek to avoid credit issues.

Conclusion

We have had numerous conversations with market participants rightly concerned about the massive amount of spread compression in the high yield and loan markets. While this is unarguable, what is also reality is the incredible size and depth of the leveraged finance markets. The size of the U.S. dollar high yield and leveraged loan market is over $3 trillion.[3] This represents nearly 30% of the corporate credit markets.[4] Yet for some reason, it still seems to be viewed as almost a throwaway allocation in portfolios. We would argue that these two asset classes should now be part of the new "core" of fixed income portfolios.

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[3] High yield market size of $1,632 billion, 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. June 27, 2014, p. 42. The Leveraged Loan Market Size of $1,527 billion as of 3/31/14, Blau, Jonathan, James Esposito, and Daniyal Khan, "Leveraged Finance Strategy Weekly," Credit Suisse Global Leveraged Finance, June 27, 2014, p. 25.

[4] Total U.S. Corporate Debt market size sourced from SIFMA, "Outstanding U.S. Bond Market Debt," as of 3/31/14.

Historically, "core" fixed income consisted of highly rated corporate bonds, government/agency securities and mortgages. Holding Treasuries as a hedge against systemic risk is something we can support and understand. Yet given the yields of today, how many investors are looking to build a core portfolio with these types of securities and yields of 2.5-3.5%?[5] We would not view this as attractive and would expect many others would feel the same, yet many institutional investors seem to have ingrained in them to invest largely in these assets classes regardless of yield. We would view this as outdated thinking, as today's high yield and floating rate loan markets bear little resemblance to those of 25 years ago, when the market was just starting, yet many investors believe them to be "high risk" asset classes. For a much more detailed analysis on risk and return we would ask investors read our "New Case for High Yield: A Guide to Understanding and Investing in the High Yield Market."

The high yield and floating rate loan markets are large and growing markets, with what we see as attractive opportunities for active managers who are able to look for value and identify potential mis-priced securities. We see that an active management approach within the high yield market, complemented with the flexibility to invest in floating rate loans and dividend paying equities, as an attractive way to approach the current market environment.

Peritus I Asset Management Disclosure:
Although information and analysis contained herein has been obtained from sources Peritus I Asset Management, LLC believes to be reliable, its accuracy and completeness cannot be guaranteed. This report is for informational purposes only. Any recommendation made in this report may not be suitable for all investors. As with all investments, investing in high yield corporate bonds and other fixed income securities involves various risks and uncertainties, as well as the potential for loss. Past performance is not an indication or guarantee of future results. Historical performance statistics and associated disclosures available upon request and qualification.

[5] Yield to worst of 2.85% and yield to maturity of 2.87% on the Barclays Corporate Investment Grade Index and yield to worst of 2.32% on the Barclays Municipal Bond Index. Barclays Corporate Investment Grade Index consists of publicly issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity, and the quality requirements (source Barclays Capital). Barclays Municipal Bond Index covers the long-term, tax-exempt bond market (source Barclays Capital). Data as of 5/31/14.