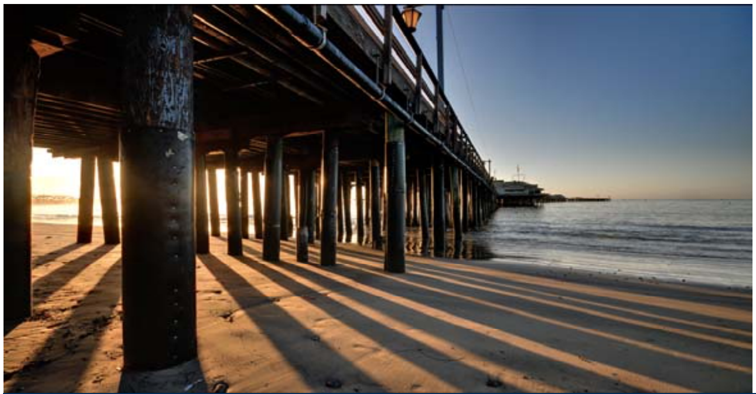


PERITUS
ASSET MANAGEMENT, LLC

Active Credit

Independent Credit Research – Leveraged Finance – July 2015

MID-YEAR UPDATE

- ***Recent spread widening for high yield bonds and loans caused by events in Greece and China gives investors what we see as an outstanding entry point and we believe that these assets need to be bought aggressively. Outside of energy (domestic oil and gas exploration and production, and certain oil services companies), we expect default rates to remain well below average.***
- ***As we expected at the beginning of the year, interest rates have not been a tailwind for high grade fixed income so far in 2015.***
- ***In this environment, we believe that an active and thoughtful portfolio of high yield bonds and loans should continue to outperform various asset classes, including equities and investment grade corporates, for the rest of 2015, just as the high yield market has outperformed in the first half.***

In like a lamb, out like a lion seems to be an accurate description of the first half of 2015. As we enter the second week of July, Greece and China have changed investor psychology (risk-off). The overall deflationary threat globally has likely changed the timing of Federal Reserve interest rate hikes as well. Oil has once again rolled over and is likely to test 2014/early 2015 lows.

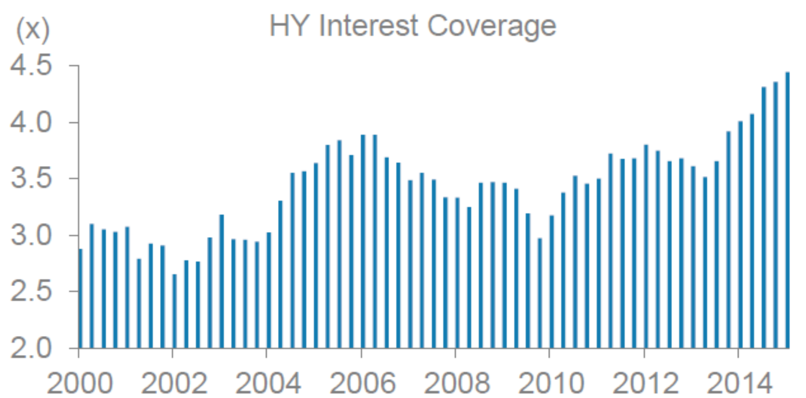
Our view entering 2015 was that rates would rise modestly from where we were. That call didn't look very good at the beginning of February as 10-year Treasury yields plunged to 1.65%, but as the year has rolled on we climbed back toward 2.5%. Even with recent events causing a flight to quality, rates are higher than where we began the year. This is important because we felt and continue to feel very strongly that active credit strategies will beat duration or interest rate sensitive fixed income strategies and sectors. We continue to believe that interest rates will not provide much of a tailwind for higher duration fixed income sectors this year.

<u>Asset Class Fundamentals</u>

There are several topics I would like to touch on as it relates to the high yield asset class, the first of which is the notion of a "bubble" in high yield bonds and loans. This is absolute nonsense. I have seen every cycle since 1985 and while this cycle which began in 2009 has not been without a few warts, it has also been very different and far more conservative. The majority of issuance was and continues to be for refinancing activity. This lowers interest expense and improves credit metrics for companies. Case and point, as noted below, high yield interest coverage (cash flow, or earnings before interest taxes, depreciation and amortization divided by interest expense) has steadily improved and at the highest levels we have seen over the past 15 years.[1]

[1] Richmond, Adam, Meghan Robson, and Jeff Fong, "Leveraged Finance Insights," Morgan Stanley Research, June 15, 2015, p. 1.

High Yield Interest Coverage Keeps Rising

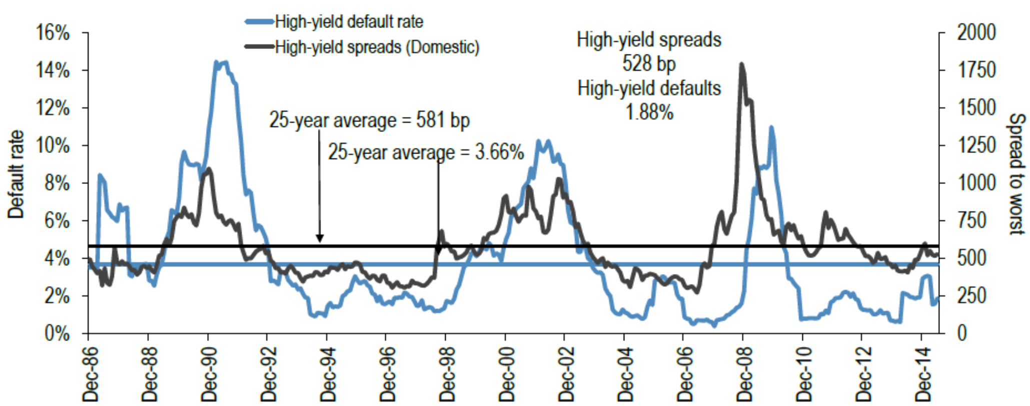


Source: Morgan Stanley Research, Bloomberg, Capital IQ

We are certainly not seeing over-extended companies in terms of their debt load or ability to service that debt, as we have often seen in historical high yield "bubbles."

Valuation is of course hugely important as well. Valuation of high yield credit is all about spread levels. But it is much more than that because without risk adjusting spreads, a false dawn can be painted. Default rates play a very large role in the risk adjustment process and we believe default rates (outside of energy) will remain well below average. Spread levels for the indexes are around historical averages, but default rates are expected to be about half of their long term averages (currently 1.9% versus a nearly 30-year history of 3.7%).[2]

High-yield spreads and default rates



Source: J.P. Morgan.

[2] Acciavatti, Peter D., Tony Linares, Nelson R. Jantzen, CFA, Rahul Sharma, and Chuanxin Li. "Credit Strategy Weekly Update." J.P. Morgan, North American High Yield and Leveraged Loan Research. June 26, 2015, p. 5. Spread referenced is spread-to-worst.

While this is certainly positive, it is also not an accurate view of the market from where we sit. We are continuing to find plenty of names with spread levels well above this level, yet with what we see as excellent credit metrics. Why does this "extra" value exist today? Two words: liquidity premium. While all the focus on the lack of liquidity over the past few months is perceived as negative, we view it as a massive positive for those investors with a time horizon longer than a week. The notion of liquidity in all markets is deceiving. This goes not only for over the counter markets in bonds and loans, but for equities as well. When the environment turns ugly, how many market makers do you know that stick their necks out to ensure an orderly market? The correct answer is 0. While legislation has reduced the number of market makers and capital available to make markets in high yield, we have never viewed it differently; liquidity is a coward that disappears at the first shot. This liquidity premium is creating attractive investment opportunities for investors who are unconstrained by factors such as tranche size minimums or maturities that limit many of the larger, passive high yield funds.

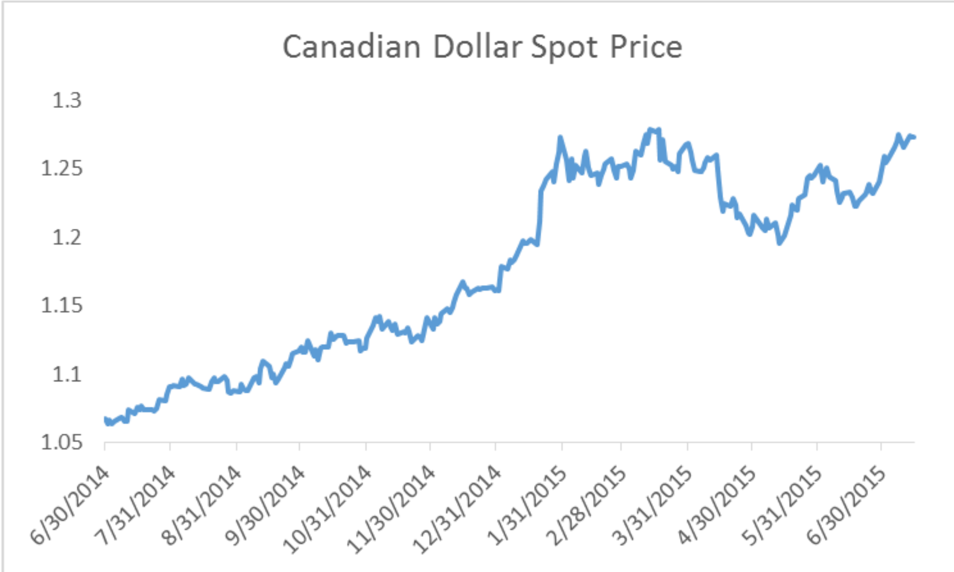
Credit cycles end badly because of dramatically over-leveraged balance sheets (1990 and 2007) and/or the funding of dubious business models with lots of leverage (1998-2000—TMT). While broadly speaking within the high yield market we are seeing reasonable value and conservative balance sheets, we have been vocal and adamant that many shale oil and gas producers fit this second broken model with their unsustainable business models and we continue to avoid them, and caution other investors to do the same. But high yield has grown up into a large, mature asset class and those avoiding the entire high yield market because of possible contagion from oil and gas should re-think that strategy. Market participants today have ring-fenced this industry and an increase in defaults for this specific industry is unlikely to lead to a blowout in the overall credit market, particularly given where interest rates reside.

<u>Peritus Strategy</u>

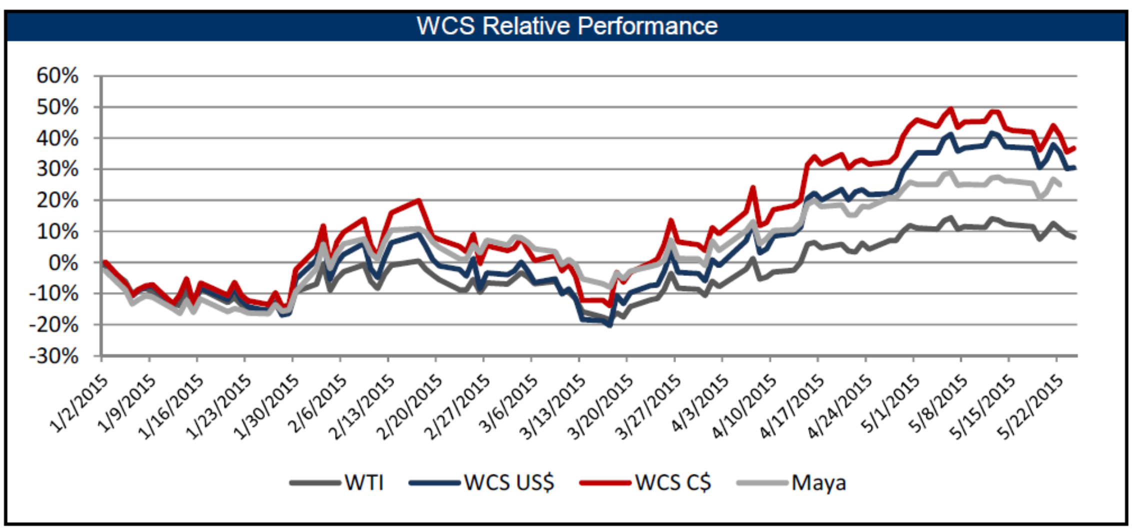
Let's turn our attention to our investment and portfolio strategy in this environment. Over the past several months, we have made a number of changes to our portfolios, including trimming our energy exposure, broadening the number of holdings and eliminating equities. In an effort to dampen volatility, we have made the decision to eliminate equities regardless of how attractive we view the yields. Additionally as we look to further lower volatility, we have increased the number of holdings more toward the wider end of our general range of 50-100 credits. Yet keep in mind that we are adding securities we still feel offer value to the end investors, not just adding names for the sake of more names.

Our portfolios today are generating what we feel is a very sustainable yield advantage over our competitors, and importantly we now have a larger number of holdings, which we believe can help us to maintain this yield advantage with less volatility. **We remain substantially underweight energy relative to the indexes and various index-based products, with only a few production companies in our portfolios**. Our primary area of focus within the exploration and production area has been on Canadian producers who get a substantial benefit from a very weak Canadian Dollar. As pictured below, the US dollar has steadily appreciated versus the Canadian dollar over the last year.[3]

[3] Price of 1 US dollar in Canadian dollar, covering the period 6/30/14 to 7/14/15. Data sourced from Bloomberg.



Oil is sold in US dollars and is translated back into Canadian dollars. So even with a WTI (West Texas Intermediate) price of $52, Canadian producers are receiving the equivalent of $66. Additionally, we are focused on heavy oil producers. One of our key themes going into 2015 was that heavy oil (WCS, or Western Canadian Select) pricing would improve versus lighter WTI oil. This has been a very good call as WCS pricing has improved significantly in 2015.[4] Couple this with the C$ and you can see why we wanted exposure to Canadian heavy oil production.



Source: Bloomberg

Additionally we have eliminated the vast majority of our energy services names which we believed had gotten way ahead of their fundamentals. I remain very concerned that both pricing

[4] Preston, Kyle, CFA, CMA, Jason Wai, and John Hunt, "Heavy Oil Fundamentals Remain Strong Despite Oil Volatility," National Bank Financial, Oil & Gas, May 28, 2015, p. 1.

and volume for service companies will be hit hard as the year progresses. There will be a time to get very aggressive in this space, but that is after we have established a true understanding of the cash flow generating power of these companies under a new pricing and production regime.

One thing that has genuinely surprised us has been the amount of capital that has been raised and deployed by private equity and distressed investors in oil and gas. My opinion is that many of them have told a great story to raise funds but know little about the actual economics of this industry. During the quarter we had some company on our skeptical view of shale economics by high profile hedge fund manager David Einhorn of Greenlight Capital, who profiled the lack of cash generating ability of the industry and profiled *Pioneer Resources* in particular. I would advise investors to avoid these shale producers like the plague. So far defaults have been relatively contained as tens of billions of dollars have poured into the space and these companies benefit from hedges previously put in place at much higher prices. However, as hedges roll off and prices once again test lows, defaults will inevitably begin to mount as cash flows start to reflect spot prices.

Longer term, we have little doubt that oil is headed much higher. Low prices do eventually cure low prices. Most knowledgeable observers of the oil markets understand that the US shale basins are still relatively short lived assets and no matter how much you reduce costs, decline curves are still 65-70% in year one for most wells based on reports we see. We see limited sustainable business model here, which is why we do not lend long term monies to these plays by purchasing their bonds or loans. At the end of the day, we expect domestic production to fall off as companies don't have the cash flow to reinvest and the decline in rig counts has an impact, which will help alleviate any excess supply globally. While the psychology of a deal with Iran could put further pressure on prices in the near term, it does not change the bigger picture. Venezuela, Libya and Nigeria are not getting healthier with $50 oil. As all of it plays out over the coming year, we will look for an opportunity to get to a market weight on our energy exposure. There is no first mover advantage here and we will continue to play possum until we believe a final bottom has been reached and valuations become more attractive.

As we head into the second half of the year, our largest industry exposure by far is Telco. We have found excellent value in this space and it has the added benefit of being considered quite defensive in nature.

Finally, we continue to find very good value in the loan market. There are a couple of reasons for this. While CLO issuance has been a robust bid, outflows over the past 18 months from ETFs and mutual funds that traffic in loans have been substantial and have created some good entry points on forced selling. Secondly, the loan market has more "orphans" than even the high yield bond market. As value investors in credit, we like orphaned names. By "orphaned" we mean a company that has issued bonds or loans, but has limited Street research coverage, thus limited knowledge or interest from potential investors, and often trade at a discount (higher yield) that we feel is higher than fundamentally justified, creating what we see as an undervalued security. Our loan investments have the added benefit of reducing the overall portfolio's duration so should rates rise further, our duration remains substantially below that of the indexes and many of our competitors.

High yield bonds and loans are an over $3 trillion market[5] that investors can't and shouldn't ignore. With a benign default profile outside of energy and the current spread levels (valuation) this space offers, we see plenty of attractive investment opportunities, especially for active managers who are able to be deliberate in where they allocate their money within the space. We have made changes to our portfolio which we believe position us well for the future and believe that today's environment provides an excellent entry point into the space.

Peritus I Asset Management Disclosure:

[5] Blau, Jonathan, James Esposito, and Amit Jain, "Leveraged Finance Strategy Weekly." Credit Suisse Fixed Income Research. July 10, 2015, p. 4, 25.