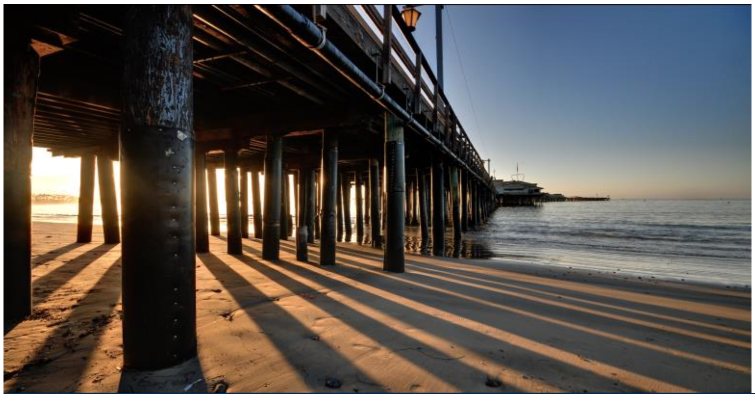


PERITUS

ASSET MANAGEMENT, LLC

Active Credit

Independent Credit Research – Leveraged Finance – October 2015

MAKING SENSE OF MARKETS

There are a number of mixed signals and misconceptions in the financial markets today. Markets are hard to make sense of, but it is often during times of confusion when investors have the most to gain. We see abundant value in today's high yield market for active, selective managers, but navigating this can be difficult with all the noise concerning this market right now. In order to better understand the high yield space, let's go through a few of the headlines and fears driving the markets, yet where the underlying circumstances don't add up.

Fear Mongering

Let's start with the fact that there have been a few high profile investors that have spoken up against the high yield market, with Mr. Carl Icahn among the more vocal. While one might speculate that Icahn has an agenda or perhaps a short trade in high yield, it is peculiar that he is so vocal against high yield bonds, calling it a bubble, when many of his equity purchases also are high yield issuers, not to mention his Icahn Enterprises is an issuer of high yield bonds.

Looking at Icahn's top ten equity holdings, over half of them are not rated or are high yield bond or loan issuers. If the high yield bonds are so risky, the equities would be infinitely more risky, as equity ranks below bonds in the company's capital structure, and if Icahn's concern is bankruptcies in this "bubble" market, then the bondholders would have to get paid back before there is any value to the equity. If he is concerned about the risk for high yield issuers, his warnings versus his holdings don't add up.

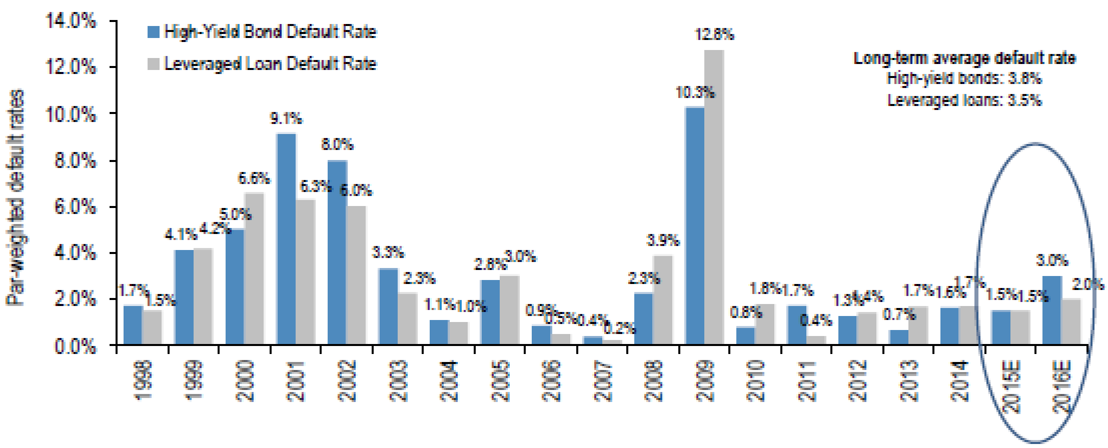
If he is referring to index-based products, we would agree with him that broadly investing in the high yield market right now does possess some heightened risk, as these products don't differentiate based on the fundamentals and viability of the investment, and there are certainly selective areas of the market we see as currently vulnerable. But, active managers like Carl Icahn and ourselves can work to avoid these problem areas and embrace the rest of the high yield market that offers what we see as great value, as we outline below. As investors, we have to be careful when the talking heads are painting entire asset classes with a broad brush.

The State of High Yield Issuers

While also sounding an alarm, a Bank of America report concluding that the high yield market is laden with highly levered companies that are struggling to grow has recently been making the rounds. This report also discusses how the decline in refinancings as a percentage of total issuance can be a signal that the cycle is turning. We believe that both of these points are misleading and don't accurately characterize today's high yield market.

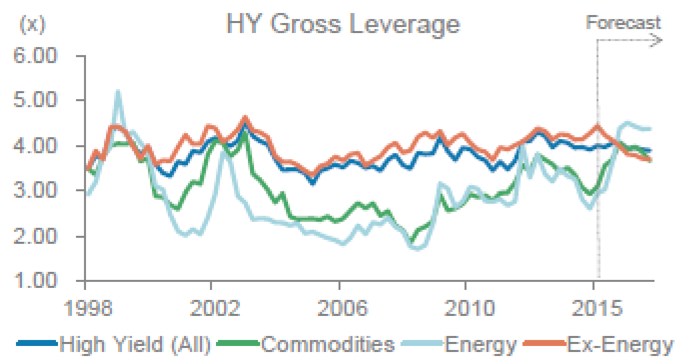
First off, on the leverage and growth front, we have been in a very slow growth environment for the extent of this entire “recovery” and high yield default rates have remained subdued the entire time, and are expected to remain well below historical averages, especially when you parse out the more vulnerable energy industry.[1]

Default rates for high-yield bonds and loans ex-Energy expected to be 1.5% through 2016

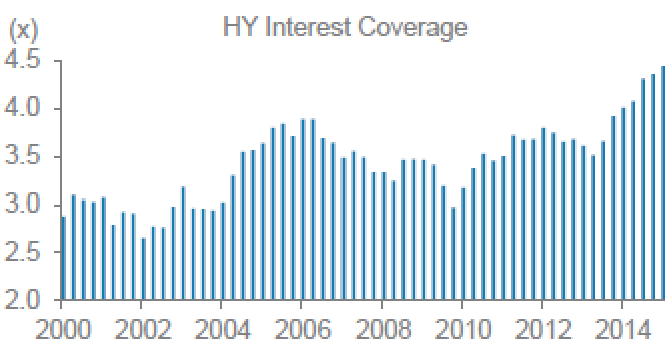


Note: 2014 default rates exclude TXU.
Source: J.P. Morgan.

In fact, recent default rates of 1.5% are less than half of historical averages, and rates are expected to remain around this level excluding energy. Additionally, leverage has remained fairly stable (and is actually projected to decline excluding energy as indicated to the right) and interest coverage (cash flow relative to interest expense, pictured below) has actually improved.[2]



Source: Morgan Stanley Research, Bloomberg, Capital IQ



Source: Morgan Stanley Research, Bloomberg, Capital IQ

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1 Acciavatti, Peter Tony Linares, Nelson R. Jantzen, CFA, Rahul Sharma, and Chuanxin Li. “Credit Strategy Weekly Update,” J.P. Morgan North American High Yield Research, April 10, 2015, p. 4-5.
2 Richmond, Adam, Meghan Robson, and Jeff Fong, “Leveraged Finance Insights,” Morgan Stanley Research, June 15, 2015, p. 1.

So the situation certainly doesn't seem to be as dire as is being painted; rather in actuality it looks to be improving for the majority of the high yield market.

On the new issue front, we too pay close attention to "use of proceeds." Generally speaking, the use of proceeds that concerns us most is when bonds are issued to fund mergers and acquisitions/LBOs and dividends. We certainly are not near this level of what we would characterize as "bad behavior" that we saw back in 2006/2007, prior to the 2008 collapse.[3]

USE OF PROCEEDS	2006	2007	2013	2014	YTD 2015
Acquisition Financing/LBO	44.2%	51.5%	17.4%	25.6%	39.9%
Refinancing	37.7%	35.0%	56.0%	53.6%	44.0%
General Corporate	15.8%	11.7%	22.3%	14.8%	13.2%
Dividend-payout	3.6%	2.0%	3.9%	2.6%	1.5%

Year to date, on a dollar basis we have seen an increase in the reported acquisition financing and decrease in refinancings relative to the last couple years, but we believe these numbers at face value are misleading. In fact, this year we have seen a small number of very large M&A deals occur that have skewed the numbers. If you were to exclude the top five new deals this year[4], all of which were for M&A, we get a total M&A use of proceeds of only about 23.5% of remaining deals and refinancings 53%...both of these virtually unchanged from 2014.

Having participated in this market for decades, we don't see the current use of proceeds as something to be concerned about or a signal that the cycle is turning—rather we see the current new issue activity as good support for our belief that markets have generally been tame and well behaved. There are always companies that add leverage at the wrong time through dividend payments to the private equity sponsor, LBOs at high valuations, or merger and acquisition (M&A) transactions, but we are certainly not seeing this at the same level as we saw heading into the 2008 collapse, after the massive leverage binge in 2006 and 2007. Currently there are selective, company specific issues with leverage, which active managers can work to avoid, but this is simply not a widespread asset class issue.

Liquidity

There is no denying that liquidity has become a well-publicized concern in today's high yield market, with much focus specifically on high yield ETFs. With the post financial crisis regulation that has curtailed market making activity by the large investment banks and dealer inventory, liquidity has decreased and volatility increased. However, we believe that arguments that liquidity concerns with the ETF space will lead to the high yield market's demise lack any real foundation and are overblown.

As we have noted in past writings (see "High Yield ETFs: Market Size, Money Flows and Liquidity"), ETFs represent a small portion of the total high yield market. ETFs alone account

[3] Acciavatti, Peter Tony Linares, Nelson Jantzen, CFA, Rahul Sharma, and Chuanxin Li. "Credit Strategy Weekly Update," J.P. Morgan North American High Yield Research, October 3, 2015, p. 38.
[4] Acciavatti, Peter Tony Linares, Nelson Jantzen, CFA, Rahul Sharma, and Chuanxin Li. "Credit Strategy Weekly Update," J.P. Morgan North American High Yield Research, September 18, 2015, p. 6.

for about 12% of "retail" high yield fund-based assets, which includes the much larger mutual fund counterpart, and ETFs alone account for about 3% of the broader high yield market.[5] Even with all the volatility we have seen this year, the largest weekly reported mutual and exchange traded fund flow was an outflow of about $3 billion (with most weekly fund flows under $1 billion)—this pales in comparison to the total $1.8 trillion market.[6] So it seems misguided to us to say that activity in such a small piece of the total market will lead to collapse.

Pre and post financial crisis, we have always seen periods of volatility when market sentiment shifts. During times of fundamental or economic fear or a "risk off" trading environment, it is natural for prices to move down, and in some cases swiftly. Then again, we can also see swift moves up/recovery as market sentiment improves—markets tend to be manic. Periods of strained liquidity are something we have always had to deal with as high yield investors, and even if we are seeing that acerbated by recent regulations, we believe it is still manageable, and actually an opportunity for active investors to acquire assets on the cheap.

Our primary concern in high yield investing is defaults. As we have noted above, we aren't seeing pervasive issues with overleverage or bad market behavior in terms of use of proceeds, and while we are in a slow growth environment, as we will discuss further below, outside of oil and commodities, we don't see a huge shift in the underlying fundamentals of much of the high yield issuers. The high yield market tends to be more domestic focused, less reliant on international sales and less exposed to the dollar strengthening than the big multinationals pervasive in the equity indexes. And with the recent wave of refinancings, we generally see good liquidity at the corporate level and manageable capital structures. For all of these reasons, we do not see a huge default cycle outside of energy and commodities on the horizon. Yet we are still getting what we believe to be very attractive yields in many of these non-commodity names. Given these liquidity concerns, high yield bond investors today are capturing liquidity premiums; liquidity is a risk for investors but it is not a fundamental risk and we believe we are getting well overpaid for this risk right now, making it a great time to selectively purchase credit. **You want to capture fear and liquidity, and not fundamentally and default driven spread widening.**

Life in a No Growth World and Rates

Let's turn to the biggest elephant in the room, or in the world for that matter: interest rates. When will the Fed begin raising rates and by how much? It is clear they want to start increasing rates in order to give themselves some flexibility if they need it down the road, all the while fulfilling their dual mandate. However, the "data" for our "data dependent" Fed seems to be getting worse globally.

What has become apparent to markets over the past few months is that we are in a no growth world. China is slowing, Europe continues to muddle along with Germany most recently showing signs of strain, and various emerging markets are facing weakness. It seems that the US is the only engine that is firing to any extent, and even here we aren't firing on all engines.

[5] 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.
[6] Source for total high yield market size: Acciavatti, Peter Tony Linares, Nelson Jantzen, CFA, Rahul Sharma, and Chuanxin Li. "Credit Strategy Weekly Update," J.P. Morgan North American High Yield Research, October 2, 2015, p. 38. Weekly fund flow totals sourced from S&P Capital IQ.

Looking at data, be it the ISM number or jobs report more recently, the global weakness is having an impact here domestically, especially given this economic cycle has already been characterized by a very lack luster recovery to begin with. While we don't expect this will trigger a recession here at home, the reality we all must face is that we are in a no growth world. So what does that mean for interest rates?

Even before the recent bout of data weakness, we have been big believers that any move the Fed makes on the interest rate front will be slow and moderate. While we feel the ultimate start date is irrelevant, most do seem to care and it is now expected by many that date may be pushed out to 2016. No matter when they start, for various reasons we don't foresee a spike in the 5- and 10-year Treasury rates, the more relevant rates for markets (rather than the Federal Funds Rate that the Fed actually controls).

Above and beyond the fact we are mired in a no growth world, inflation is another data point the Fed continually cites. With the recent decline in oil and many other commodities, we don't see any near-term inflation pressures. Because of this, along with a generally weak demand for products, we expect the Fed will be hard-pressed to get to their target inflation number of 2%. With the lack of inflation globally, 10-year sovereign bond rates across the globe are exceedingly low.

Country	10-Year Bond Yield
Switzerland	-0.22%
Japan	0.32%
Germany	0.59%
Sweden	0.66%
Netherlands	0.78%
Denmark	0.84%
Finland	0.86%
Austria	0.88%
Belgium	0.91%
France	0.97%
Canada	1.42%
Hong Kong	1.52%
Italy	1.69%
United Kingdom	1.80%
Spain	1.83%
United States	2.03%
Israel	2.17%
Portugal	2.35%
Singapore	2.36%
Australia	2.61%

The US is an outlier with our 10-year at just over 2%. Even countries that were on the precipice not too long ago, like Italy and Spain, have 10-year bond yields about the same or under that of the US.[7] We see this as yet another reason that even if the Fed starts increasing the Federal Funds Rate, we don't see that translating to big moves in the 5- and 10-year Treasury rates, as we would expect buyers to step in constraining rates on US Treasuries.

Some additional factors to keep in mind as we assess the likelihood of a spike in rates:

- Unemployment—while the headline unemployment number has improved, workforce participation has not, and we know this is something the Fed pays attention to based on previous comments.
- Wages—we are also not seeing any meaningful improvement in wages, which will hamper growth in consumer spending.
- Consumer spending—approximately two-thirds of economic activity is consumer driven. With nearly 50% of Americans now on some form of government assistance and the massive number

[7] Data as of 10/6/15, sourced from Bloomberg.

of people that have fallen out of the job market, there is much less spending power today than a decade ago. Many have said that the energy cost savings will spur consumer spending but that just isn't playing out as money is being used to shore up other cost increases.

- Dollar—the strong dollar continues to cut into corporate profits, manufacturing, and exports, as witnessed by the recent ISM data and reported corporate earnings by the large multinationals.

Given the large portion of under-employed/people dropping out of the workforce, curtailed consumer spending, and an appreciating dollar, we believe expectations to get back to a 4% - 5% growth rate are unrealistic, and with a lack of strong economic growth, we believe the Fed will be hindered in how aggressive they can be in raising rates.

On a final note, it is important to recognize the recent activity in Treasury prices. The Treasury markets aren't reacting to the rising rate talk, with the 10-year going from 2.35% to 2.06% during the third quarter[8] and down a full percent since early 2014. 3-month T-Bills were recently issued at a 0% yield. It seems these buyers have no expectation of a near-term rate hike. The Treasury markets are telling us something: the world is weak and the Fed will do very little, if anything. With the data like the recent jobs number, we wouldn't be surprised to see the 10-year revisit the 2015 lows.

Even if we don't expect the Fed to aggressively raise rates, like it or not, the prospect of higher interest rates is on the mind of many investors. The talking heads in the financial media keep jumping to the conclusion that if interest rates are going up, this is bad for bonds, including high yield bonds. For much of the "bond" market, such as longer duration municipal or investment grade bonds, this will likely be true; however, for the high yield bond market this assumption is perplexing, given that the high yield market's history tells us a different story. Looking back at over 30 years of data, the high yield market has performed well in periods of rising rates, especially relative to other fixed income asset classes:[9]

Year	J.P. Morgan High Yield Bond Index Return	J.P. Morgan Investment Grade Corp Bond Index Return	S&P 500 Index Return	Barclays Municipal Index	Change in 5 Yr Treasury Yield (bps)
1980	4.3%	0.5%	32.5%	-8.9%	2.21
1981	10.4%	2.3%	-4.9%	-10.2%	1.38
1983	20.3%	9.3%	22.6%	8.1%	1.44
1987	6.5%	1.8%	5.3%	1.5%	1.59
1988	11.4%	9.8%	16.6%	10.2%	0.73
1992	16.7%	9.1%	7.6%	8.8%	0.07
1994	-1.6%	-3.3%	1.3%	-5.2%	2.62
1996	13.0%	3.7%	22.9%	4.4%	0.83
1999	3.4%	-1.9%	21.0%	-2.1%	1.80
2003	27.5%	7.9%	28.6%	5.3%	0.51
2004	11.5%	5.3%	10.9%	4.5%	0.36
2005	3.1%	1.7%	4.9%	3.5%	0.74
2006	11.5%	4.3%	15.8%	4.8%	0.34
2009	58.2%	16.7%	26.5%	12.9%	1.13
2013	8.2%	-0.8%	32.4%	-2.6%	1.02
AVERAGE	13.6%	4.4%	16.3%	2.3%	

[8] Daily Treasury Yield Curve Rate, source U.S. Department of Treasury, for the period 6/30/15 to 9/30/15.

[9] High yield and investment grade data sourced from: Acciavatti, Peter Tony Linares, Nelson R. Jantzen, CFA, Rahul Sharma, and Chuanxin Li. "2008 High Yield-Annual Review," J.P. Morgan North American High Yield Research, December 2008, p. 113; "High-Yield Market Monitor," J.P. Morgan, January 5, 2015, p. 3; and "2014 High-Yield Annual Review," J.P. Morgan, December 29, 2014, p. 292. Treasury data sourced from

Not only has the high yield market posted an average return of 13.6% in the 15 calendar years since 1980 during which we saw rates rise over the annual period, but it has had only one down year over this time frame. Rates generally go up during periods of economic growth which is generally favorable for corporate credit. So what happens if we are wrong and the economy strengthens significantly, and rates along with it? Well history would indicate high yield investors are in one of the better asset classes for that scenario.

The Federal Reserve may start raising rates this year or next to get the ball rolling, and may move rates up a quarter of a point a few times over the next year, but we expect their move to be fairly minimal and largely be irrelevant. We may even see the financial markets move up on an actual rate move as it removes the uncertainty. For all of the talk of a hit to high yield, we don't expect a moderate rate move to have a meaningful impact. For rates to really accelerate, we need to see much stronger global growth, which again would be a positive for corporate credit in terms of lowing the already low default rate risk as income and cash flow improved.

For all of those people that are avoiding the high yield asset class due to a potential rate increase or waiting until we see what the Fed does, or even attempting to time a bottom, are missing what we see as a great opportunity to generate yield. With many now expecting that we don't see a rate move until March of 2016, almost six months away, and a high yield index now yielding about 8.4%[10], you would miss over 4% of income, irrespective of any pricing upside, by sitting on the sidelines waiting for a tiny 25 bps move by the Fed.

Valuation of the High Yield Market

Let's pull all of this together and look at what it means in terms of the current value proposition in the high yield market. First off, we see slow growth as a great environment for credit investors. During these sorts of times, we don't see any sort of meaningful empire building or M&A activity (of note, recent M&A activity has been focused on the large, investment grade multinationals not high yield). Instead, management is focused on the balance sheet, conserving liquidity, and paying their bills.

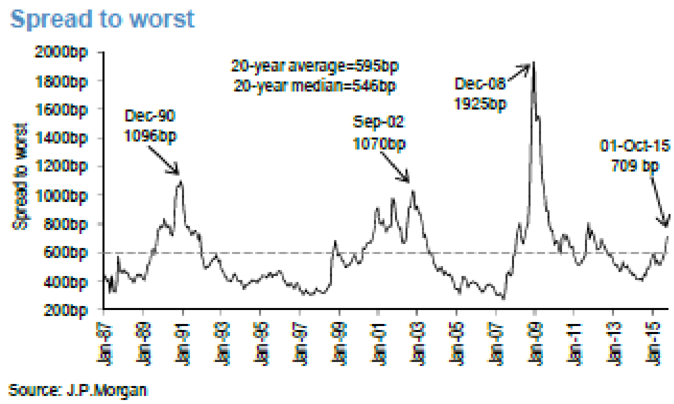
We don't need growth for value to be had in the high yield market. Unlike equities where investors need earnings to increases to drive equity prices up, we just need currently manageable capital structures and companies to continue paying their bills. In fixed income we have built in call and maturity dates providing us an end game, barring a default. This means that over time, the price of the bond generally moves toward the call or maturity price as those dates approach, all the while providing income as you muddle through the price noise along the way.

As we look at the high yield market, we view spreads as a primary way to assess the value proposition. High yield spreads are at levels not seen for the past three years.[11]

Bloomberg (US Generic Govt 5 Yr). The J.P. Morgan High Yield bond index is designed to mirror the investible universe of US dollar high-yield corporate debt market, including domestic and international issues. The J.P. Morgan Investment Grade Corporate bond index represents the investment grade US dollar denominated corporate bond market, focusing on bullet maturities paying a non-zero coupon. S&P 500 data sourced from Bloomberg. Barclays Municipal Bond Index covers the long-term, tax-exempt bond market (source Barclays Capital).

[10] Acciavatti, Peter Tony Linares, Nelson Jantzen, CFA, Rahul Sharma, and Chuanxin Li. "Credit Strategy Weekly Update," J.P. Morgan North American High Yield Research, October 2, 2015, p. 29.

[11] Acciavatti, Peter Tony Linares, Nelson Jantzen, CFA, Rahul Sharma, and Chuanxin Li. "Credit Strategy Weekly Update," J.P. Morgan North American High Yield Research, October 2, 2015, p. 29. Based on the spread to worst of comparable maturity Treasuries.



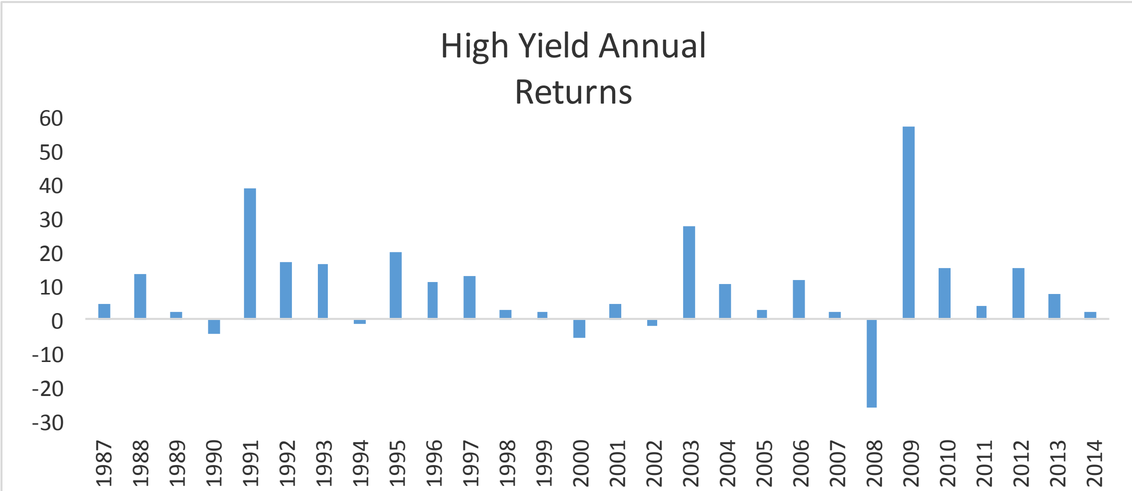
Current spreads of 709bps offered for investors are nearly 30% above historical median spread levels for the high yield market, as well as massively above the levels we saw mid-cycle (2004-2006) during the last economic cycle. It is also important to note that high yield bond relative to investment grade bond spreads are also offering what we see as compelling value versus historical levels.[12] So, where exactly is that bubble that Icahn and some others are claiming again?

BOND SPREAD COMPARISONS	High Yield	High Yield Less Investment Grade
10/1/2015 Level	709bp	434bp
All Time low	266bp	176bp
20 year median	546bp	310bp
% above/below 20yr median	29.9%	40.0%
2004 median	452bp	353bp
2005 median	379bp	293bp
2006 median	350bp	261bp
Median 2004-2006	374bp	286bp
% above/below 2004-2006 median	89.6%	51.7%

With the spread widening that we have seen so far this year, we are posting negative returns year-to-date for the high yield market, which is a rare occurrence. Historically there have only been five years of negative returns going back nearly thirty years.[13]

[12] Acciavatti, Peter Tony Linares, Nelson Jantzen, CFA, Rahul Sharma, and Chuanxin Li. "Credit Strategy Weekly Update," J.P. Morgan North American High Yield Research, August 15, 2015, p. 4 and October 2, 2015, p. 29.

[13] Based on the Bank of America Merrill Lynch High Yield Index, data for 12/31/86 to 12/31/14. Data sourced from Bloomberg. The Bank of America Merrill Lynch High Yield Index monitors the performance of below investment grade U.S. dollar-denominated corporate bonds publicly issued in the U.S. domestic market.



Furthermore, it is worth keeping in mind the performance of the high yield market following these periods of negative returns.[14]

	High Yield	S&P 500
Averge Annual Total Return (1986-2014)	9.57%	11.96%
Average Annual Negative Return (1990, 1994, 2000, 2202, 2008)	-7.76%	
Average One Year Return after a Negative Annual Return for HY	29.95%	22.26%
Average Three Year Annualized Return after a Negative Annual Return for HY	17.12%	14.24%

We have not only seen strong, double digit returns on average in the year following a negative return for the high yield market, but the strong returns persisted for the three years following the negative return year. And the average returns in the years following negative return years far outweighed the negative years. Also of note, high yield performed better than equities after the negative years.

We believe the recent decline for the high yield space is now offering compelling future return prospects for investors. Not only are we seeing the best value that we have seen in the high yield market over the past few years, but it is important to point out that this is in the face of well below average default rates, bond maturities pushed out for several years, and improving cash flow coverage relative to interest (meaning more room for potential cash generation at the corporate level). While there are certainly names to avoid in the energy and commodity space—areas where we do expect default rates to meaningfully tick up—we believe the fundamentals are relatively tame for much the rest of the high yield market. We don't expect that we are on the

[14] "High yield" is represented by the Bank of America Merrill Lynch High Yield Index. S&P total return data provided. Data sourced from Bloomberg.

verge of the credit cycle going bust; thus, we see the current environment as a terrific opportunity for active investors in the high yield debt markets.

Investors need to generate yield somehow and the equity market is not the place to do that given this no growth world. We believe the high yield market is more than compensating you for the risks in today's market, as a J.P. Morgan report recently noted:[15]

> *With valuations cheapening rapidly over the past few weeks, we believe there is more than enough spread premium present to compensate investors for the vast amount of uncertainty. A total market spread of 709bp implies a default rate one year from now of 6.4%, more than double our 3% 2016 forecast. Even more relevant, the high yield market's spread excluding the Energy and Metals/Mining industries stands at 611bp, 148bp wider since the beginning of June and implying a 4.8% default rate. For context, this is triple our 1.5% ex-commodities [default] forecast for 2016.*

We believe the fear mongering and rising rate concerns are overblown by the financial media and that the current spread levels are well compensating investors for liquidity concerns. The recent spread widening virtually across the board has created a great opportunity for active investors who can work to make sense of the market and are able to sift through credits to determine the fundamentally strong from the weak. For those sitting on the sidelines "waiting and seeing," you may well miss the opportunity. You could be waiting months and maybe even quarters for the Fed to actually make a move, all the while missing the very attractive, tangible yield we see currently offered by the high yield debt market.

[15] Acciavatti, Peter Tony Linares, Nelson Jantzen, CFA, Rahul Sharma, and Chuanxin Li. "Credit Strategy Weekly Update," J.P. Morgan North American High Yield Research, October 2, 2015, p. 5.