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Stop Timing the Market, Start Optimizing Asset Exposure

The Case for Long Term Exposure to BB-B Rated Short Duration Bonds

Peter Duffy, CFA and Matthew Bogdan

Introduction: Two Key Points

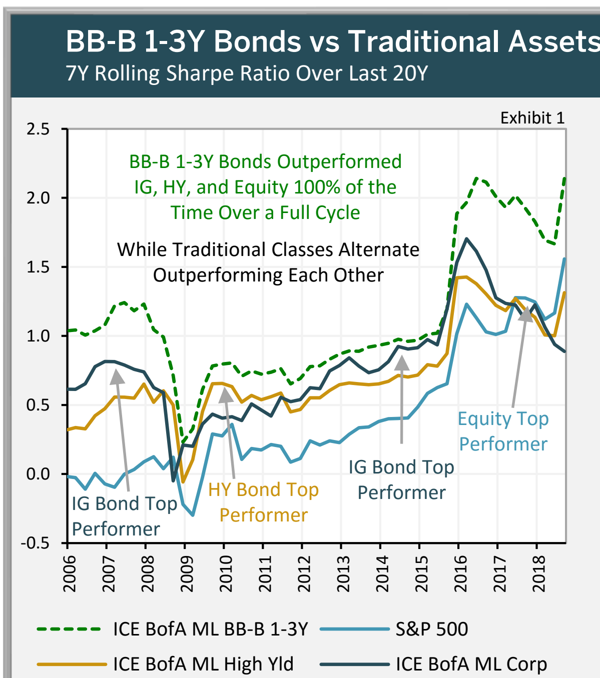
In this paper, we will focus on two consistent and measurable trends in historical markets: (1) BB-B rated short duration bonds exhibit an outperformance anomaly and (2) Attempting to "time the market" overwhelmingly leads to underperformance. We believe these two factors make a strong argument for long term, static exposure to BB-B rated bonds within the 1-3 year maturity range.

Market Timing: Traditional Asset Classes

Historically, each market cycle (7 years on average) has a traditional asset class that outperformed the rest. As seen in exhibit 1, classes take turns depending on the market environment. If a manager successfully predicts certain factors – interest rates, credit spreads, recessions, etc. – and allocates to the winning class, they outperform. But that's a big "if", as these factors are notoriously hard to predict.

The Alternative: Consistent BB-B Rated 1-3 Year Bond Outperformance

There's nothing wrong with making a tactical market decision, but bets can be hedged without sacrificing returns. Over a full cycle, BB-B 1-3 year bonds have historically outperformed traditional asset classes 100% of the time. This is due to a unique balance; investment grade-like downside, high yield-like upside, and low sensitivity to macro factors such as interest rate and credit spread fluctuations.



As of 10/31/2018, Source: Bloomberg, Collaborative Fund

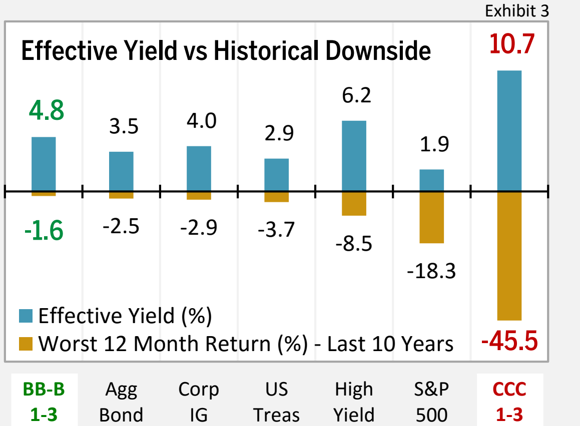
Timing Isn't Everything: Misconceptions of BB-B Rated 1-3 Year Bonds

We recently asked Morningstar why they lack a dedicated short duration high yield category, which is currently lumped within the broad high yield category. Where as investment grade bonds have long, intermediate, short, and even ultrashort categories. Their answer was that "the market just isn't familiar enough with the asset class", which consists of only 19 funds vs 140 short-term category funds and 74 ultrashort category funds. This lack of familiarity leads to key misconceptions. For example, the market clearly views high yield bonds as a timing class, with $9.2bn in year-to-date institutional fund outflows. This was the highest of 104 fund categories amid fears of a bear market and rising spreads. As shown below, BB-B 1-3 year bonds exhibit characteristics opposite to those timing factors. However to many traditional investors, the idea of holding speculative grade debt in a mid-to-late cycle environment is unfathomable.

Not All HY Bonds Perform the Same

Wide Dispersion Amongst Speculative Ratings

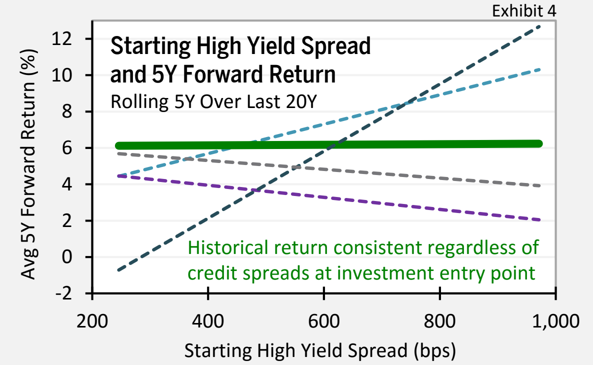
Exhibit 3



It's Not a Credit Spread Timing Trade

Limited Sensitivity to Credit Spread Fluctuations

Exhibit 4

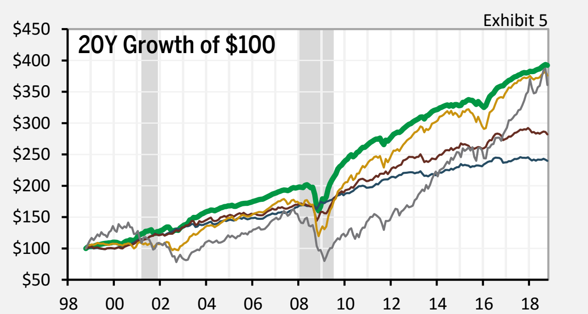


Asset Class:	S&P 500	High Yld	BB-B 1-3	Corp IG	Corp IG 1-3
Line Slope:	18.5	8.1	0.0	-4.0	-4.9

It's Not a Recession Timing Trade

Outperformed Over Last 2 Recessions

Exhibit 5

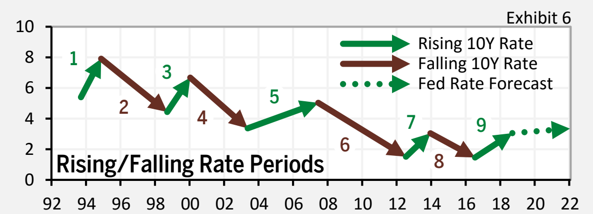


Last 20Y	Ann. Return	Std. Dev.	Sharpe Ratio	2001 Recession	2008-09 Recession
S&P 500	6.62	14.41	0.39	-7.18	-35.46
High Yld	6.85	8.97	0.57	-2.45	-4.49
BB-B 1-3	**7.07**	**5.22**	**0.97**	**4.36**	**6.62**
Corp IG	5.32	5.19	0.66	7.44	1.72
Agg Bond	4.47	3.37	0.76	6.45	7.54

It's Not an Interest Rate Timing Trade

Limited Sensitivity to Interest Rate Fluctuations

Exhibit 6



#	Rising Rate Period	BB-B 1-3	Corp	Treas	Agg
1	10/1/1993 - 11/30/1994	7.23	-3.71	-3.82	-3.03
3	10/1/1998 - 1/31/2000	6.66	-0.95	-1.73	-0.61
5	6/1/2003 - 6/30/2007	7.04	3.18	2.07	2.94
7	8/1/2012 - 12/31/2013	7.27	0.62	-2.77	-1.14
9	8/1/2016 - Present	4.83	-0.11	-2.06	-0.94
#	Falling Rate Period				
2	12/1/1994 - 9/30/1998	8.86	11.30	10.73	10.54
4	2/1/2000 - 5/31/2003	8.97	11.56	10.73	10.49
6	7/1/2007 - 7/31/2012	8.39	7.88	7.07	6.97
8	1/1/2014 - 7/31/2016	3.68	6.12	5.00	4.82

As of October 31, 2018. Source: Bloomberg, Morningstar Direct, Indices: S&P 500, ICE BofA ML US HY Master, ICE BofA ML US HY BB-B 1-3 Year, ICE BofA ML US Corp Master, ICE BofA ML US Treas Master, BBgBarc US Agg Bond. Indices are unmanaged and not available for direct investment. Index comparisons have limitations as volatility and other characteristics may differ from a particular investment. Past Performance is no guarantee of future results.

Perfect Timing: the Great Recession

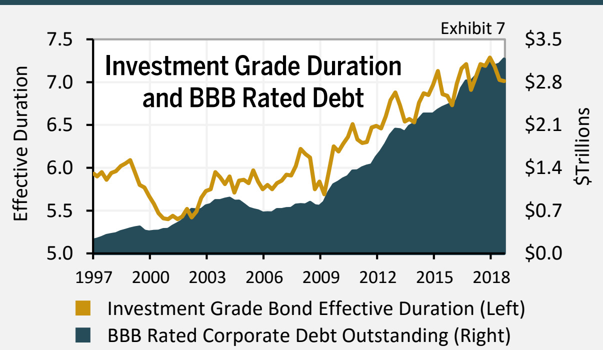
Robert James Shiller famously predicted the 2008 economic crisis in 1996. His timing was a little off. 12 years and 138% in total S&P 500 returns later, he was correct. The Barclays Agg Index returned 8% in the ensuing recession while the S&P 500 fell 35%. Perfect timing of these two classes would have resulted in a full period gain of 156%. BB-B 1-3 year bonds returned 127% over the same period (113% pre-crisis, 7% recession), significantly outperforming both classes but underperforming the theoretical portfolio. However, perfect timing was so rare in this instance that the few who timed the Great Recession had movies made about them, while those who did not are still recovering. Without the benefit of hindsight, BB-B 1-3 year bonds provided a high reward and lower risk alternative to Wall Street's "animal spirits".

Break Away from the Herd: Historical Interest Rate Impacts on Returns

To quote the SEC, "Past performance does not guarantee future results." Interest rates fell for 36 years until bottoming in 2016, seemingly putting an end to a super cycle that acted as a tailwind for long duration credit returns. By the flows, the herd believes that what worked then will continue to work now. As of 9/30/2018, intermediate-term bonds remain the top Morningstar institutional flow category, with an average duration and maturity of 5.4 and 7.4 years, respectively. Its $71bn of inflows over the last year doubled the next highest category and accounted for an impressive 25% of all net flows. Yet the category is down 2.4% year-to-date amid rising rates. The underperformance trend may continue, or it may not. In the meantime, BB-B 1-3 year bonds are up 3.0%. The asset class allows an investor to distance themselves from the herd without sacrificing return potential and reduces the need to predict interest rates, spreads, or recessions.

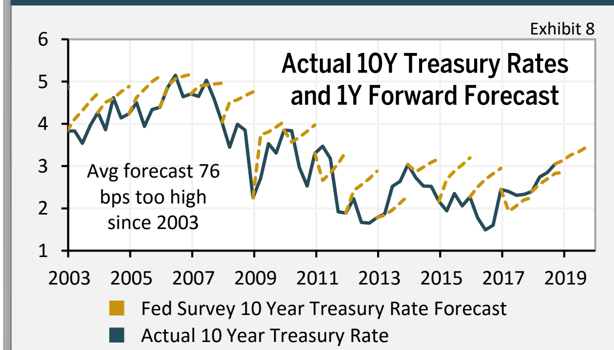
Risks of Herding into Long Duration

IG Duration and BBB Ratings at Historical Highs



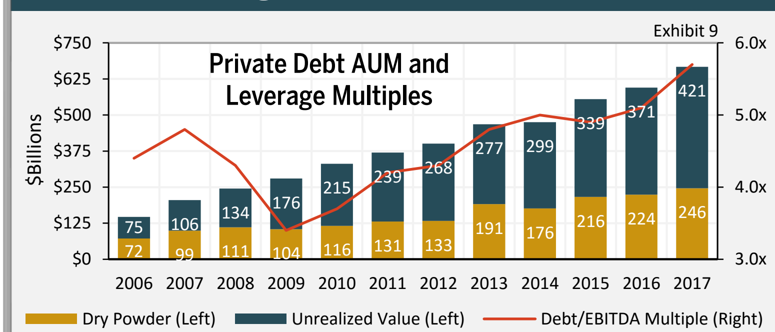
Risks of Predicting Interest Rates

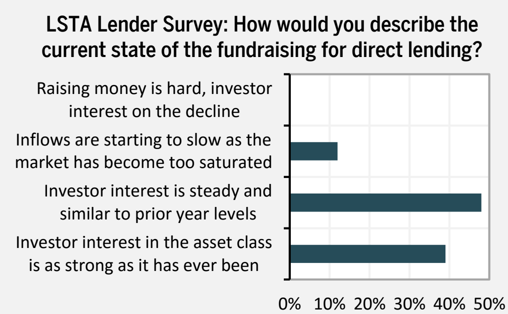
Economists Consistently Wrong in Forecasts



Risks of Herding into Private Market

Untested Private Debt at Historically High AUM and Multiples





As of October 31, 2018. Source: Morningstar, S&P Global Market Intelligence, Bloomberg, Federal Reserve Bank of Philadelphia Survey of Professional Forecasters. Indices: ICE BofA ML US HY BB-B 1-3 Year, ICE BofA ML BBB US Corporate, ICE BofA ML US Corp Master. Effective duration calculated off ICE BofA ML US Corp Master Index. Indices are unmanaged and not available for direct investment. Past performance is no guarantee of future results.

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Active Management: Optimization of BB-B Rated 1-3 Year Bonds

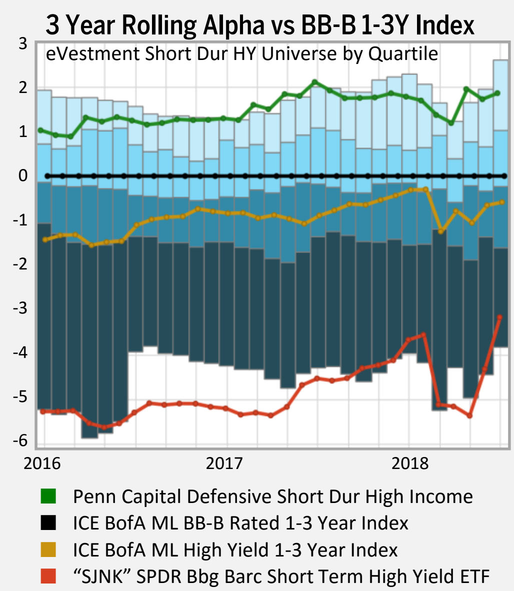
At Penn Capital, we believe the short duration high yield universe can be optimized with 3 key points: (1) High conviction opportunity targeting, (2) BB-B rated quality focus, and (3) short maturity and duration style discipline. Executed correctly, these factors can amplify the risk-return durability and characteristics historically seen from the BB-B rated 1-3 year index. Exhibit 10 breaks down these factors and historic results by index, ETF, and peer universe.

Optimal Portfolio Characteristics

Penn Capital Has Consistently Exhibited Top Ranked Outperformance

Exhibit 10

Strategy	Penn Capital Short Dur	BB-B 1-3Y Index	eVestment SDHY Univrs	HY 1-3Y Index	SDHY ETF "SJNK"
# of Companies	87	146	162	189	428
High Conviction	✓	X	X	X	X
% BB or Higher	63.7	61.5	50.7	48.6	41.0
% B Rating	36.3	38.5	39.2	35.4	41.1
% CCC or Below	0.0	0.0	10.1	16.0	17.9
Quality Focus	✓	✓	X	X	X
Wtd Avg Maturity	2.2	2.1	3.4	2.1	3.4
Mod Duration	1.6	1.9	2.3	1.9	2.3
Style Discipline	✓	✓	X	✓	X
3 Year Alpha	1.9	-	-0.3	-0.6	-3.2
3 Year Sharpe	3.0	2.3	1.9	2.1	1.4
Outperformance	✓	✓	X	X	X



Conclusion: Capital Preservation with High Income

BB-B 1-3 year bonds are an underutilized, misunderstood, durable, and alternative asset class. While never a top or bottom performer in any given calendar year, the class is not ideal for market timing. That's a good thing. When held over a full cycle, the bonds have consistently delivered unparalleled performance. The class can be further optimized with active management. However most strategies hold CCC quality and longer maturity bonds to increase yield and capacity potential. We view this as a suboptimal mistake. BB-B 1-3 year bonds exhibit hybrid characteristics and should be considered as an allocation within a portfolio's investment grade, alternative, and/or high yield bucket, depending on the desired effect. Effects include the enhancement of yield, risk-return, interest rate/spread insensitivity, and/or diversification. The case for BB-B 1-3 year bonds is further amplified by the current environment, with durability to today's rising rates, low yields, late cycle, and market volatility.

Peter Duffy, CFA *Senior Portfolio Manager, Senior Partner*

Peter Duffy serves as the portfolio manager for Penn Capital's Defensive Short Duration High Income strategy. Mr. Duffy began his career with Penn Capital in 2006. Prior to joining, he was a Director for Deutsche Asset Management's global high yield debt team. Previously, he worked on mergers & acquisitions at GE Capital and as a management consultant at Arthur Andersen LLP. He received a BS in Finance *summa cum laude* from Villanova University and an MBA from The Wharton School of the University of Pennsylvania.

As of September 30, 2018. Source: eVestment, Bloomberg, Indices: ICE BofA ML US HY BB-B 1-3 Year, ICE BofA ML US HY 1-3 Year. The performance results presented above are prior to the deduction of actual investment advisory fees ("gross of fees") which includes reinvestment of income. Full composite and important "gross of fees" disclosure information can be found at the back of this presentation. Indices are unmanaged and not available for direct investment. Index comparisons have limitations as volatility and other characteristics may differ from a particular investment. Past Performance is no guarantee of future results.

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Indices are unmanaged and not available for direct investment. Index comparisons have limitations because indexes have volatility and other material characteristics that may differ from a particular investment. The ICE BofA ML US HY Cash Pay BB-B Rated 1-3 Year Index is a subset of The Bank of America Merrill Lynch US Cash Pay High Yield Index, which tracks the performance of non-investment-grade corporate bonds with a remaining term to final maturity less than three years and rated BB-B. The ICE BofA Merrill Lynch US High Yield Index tracks the performance of US dollar denominated below investment grade rated corporate debt publicly issued in the US domestic market. The S&P 500 Index is a capitalization weighted index of 500 stocks intended to be a representative sample of leading companies in leading industries within the U.S. economy. The Bloomberg Barclays US Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed rate taxable bond market. The ICE BofA Merrill Lynch US Treasury Index tracks the performance of the US dollar denominated sovereign debt publicly issued by the IS government in its domestic market. The ICE BofA Merrill Lynch US Corporate Index tracks the performance of US dollar denominated investment grade corporate debt publicly issued in the US domestic market. The S&P/LSTA Leveraged Loan Index is a market value-weighted index designed to measure the performance of the U.S. leveraged loan market based upon market weightings, spreads and interest payments.

Defensive Short Duration High Income Composite February 1, 2013 - present

	Defensive Short Duration High Income Gross of Fees Return	Defensive Short Duration High Income Net of Fees Return	ICE BofA ML US HY Cash Pay BB-B Rated 1-3 Yrs	3 Year Standard Deviation Defensive Short Duration Composite	3 Year Standard Deviation ICE BofA ML Cash Pay BB-B Rated 1-3 Yrs	Number of Accounts in Composite	Composite Size (Millions)	Annual Standard Deviation	Firm Assets Under Management (Millions)	Percentage of Firm's Assets
YTD 3Q 2018	2.79	2.44	3.28	N/A	N/A	5 or fewer	$82.03	N/A	$2,967.44	2.76%
2017	4.62	4.04	4.70	1.61	2.62	5 or fewer	$77.32	N/A	$3,772.83	2.05%
2016	7.43	6.86	10.56	2.01	2.78	5 or fewer	$75.32	N/A	$4,980.63	1.51%
2015	2.73	2.24	0.30	N/A	N/A	5 or fewer	$79.11	N/A	$5,661.47	1.40%
2014	1.45	0.91	1.97	N/A	N/A	5 or fewer	$69.67	N/A	$7,143.46	0.98%
2013	5.27	4.76	5.37	N/A	N/A	5 or fewer	$35.52	N/A	$6,751.27	0.53%

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<u>Composite Characteristics</u>: The Defensive Short Duration High Income Composite is defined to include separate accounts with assets over $1,000,000. These accounts solely invest in cash paying fixed income securities of U.S. based companies, with an average portfolio maturity of 3 years and minimum bond credit rating of Split-B Rated. The Short Duration High Yield strategy seeks to preserve investors' capital while managing duration and generating current income. Effective December 1, 2017, Penn Capital changed the name of the composite from the Short Duration High Yield Composite to the Defensive Short Duration High Income Composite. The Defensive Short Duration High Income Composite inception date and creation was January 31, 2013. The Defensive Short Duration High Income Composite is comprised of all separate accounts that have been managed by Penn Capital for one full calendar quarter. Accounts which have a significant cash flow (20% or more on the transaction date) will not be removed from the composite.

<u>Calculation Methodology</u>: The Defensive Short Duration High Income Composite is shown as total returns, which assumes reinvestment of dividends and capital gains, with no reductions for taxes, presented before the deduction of actual investment advisory fees, are calculated in U.S. dollars, and computed on a dollar-weighted-rate-of-return-basis. Performance results have been presented both prior to the deduction of investment advisory fees ("gross of fees") and after the deduction of actual investment advisory fees ("net of fees"). For example, an account with a compounded annual total return of 10% would have increased by 159% over ten years. Assuming an annual advisory fee of 1.0%, this increase would be 137%. Internal dispersion is calculated using the asset-weighted standard deviation of all portfolios that were included in the composite for the entire year. For annual periods with less than six accounts, dispersion is not displayed as it is not statistically meaningful. Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request. All returns are calculated net of transaction costs and gross of custodial fees and taxes on dividends and interest.

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