

High Yield Strategies

Executive Summary

The high yield (“HY”) market posted a positive quarter as intermediate and long-term interest rates stabilized, spreads narrowed, and economic fundamentals remained solid.

Hot Summer

The summer of 2018 was one of the hottest on record. The HY market was pretty hot too. Strong corporate credit fundamentals trumped concern about an active Fed Reserve (“Fed”) and a flatter yield curve. According to JP Morgan, publicly traded HY companies reached post-Lehman highs for both EBITDA margins and interest coverage and are nearing post-Lehman lows regarding total leverage. We would tend to agree that 2019 will see a lower default rate than 2018.

Spreads touched post-Lehman lows, and CCC-rated bonds outperformed given their sensitivity to economic activity and lower sensitivity to interest rates. BB-rated credits again underperformed, however, finished in-line with B-rated bonds and only slightly trailed the broad market. During 3Q 2018 (“3Q”), the Cable/Satellite sector led the way for returns along with Services and Healthcare, whereas Automotive, Housing, and Retail returned positively but lagged the rally.

Trade War or Trade Spat?

The rally in credit, as well as the small-cap oriented Russell

2000 Index (which overlaps with much of the HY universe), occurred despite a backdrop of concern on trade wars. Despite reprisal exchanges occurring across borders, securities of these mostly US-centric companies were relatively unscathed given their underexposure to export markets. The markets may also be treating new tariffs as a negotiating ploy and not permanent policy; we would tend to agree.

Capital Market Indicators

Despite over \$25b in HY mutual fund outflows year-to-date (“YTD”), which already exceeds the worst calendar year ever, market technicals showcased their resilience thanks to historically low net new supply. HY bond gross new issue volume for 1Q 2018 totaled a modest \$42b, however, the amount used to fund calls, tenders, and maturities exceeded this figure. According to JP Morgan, the HY market is on pace for negative net new supply on the year. Further, the value of rising stars, or bonds upgraded to investment grade, have exceeded fallen angels during 3Q and YTD. The overall quality of issuance so far this year continues to be high,

with only 1% of proceeds YTD used by lower-rated issuers for non-refinancing purposes, on pace for the lowest since 2002. By comparison, this number was 2.2% in 2013 and over 5% in 1998 and 2007. Likewise, despite slightly higher borrowings to fund dividends, non-cash pay issuance remains near all-time low levels. Concurrently, the equity market continues to be an important source of capital. According to Bloomberg, primary and secondary equity issuance of \$120b YTD was on pace to top both 2016 and 2017. In these regards, capital markets remain open to higher quality sub-investment grade companies to grow their businesses responsibly, even if doing so by acquiring other companies with modest additional leverage.

Attribution

Defensive High Yield

During 3Q, our Defensive HY strategy outperformed the ICE BofA Merrill Lynch BB-B Rated Non-Distressed Index as an overweight to B-rated credits continued to outperform more rate-sensitive BB-rated credits. An underweight position and strong security selection within the Retail/Apparel and Building/Building Materials

sectors added value. Security selection within commodity-oriented industries, such as Energy and Metals/Mining, as well as within Utilities and Technology sectors, also contributed. Other than cash drag, the main detractors were security selection within Aerospace & Defense and Healthcare. Bond yield curve positioning added some value as US Treasury rates continued to flatten, but for accounts with a loan allocation, senior floating rate loans underperformed the bond rally in 3Q.

Opportunistic High Yield

During 3Q, our Opportunistic HY strategy performed in-line with the ICE BofA Merrill Lynch US HY Constrained Index as the CCC-rated and B-rated segments of the credit market continued to outperform in the rising rate environment. An underweight position and strong security selection within the Retail/Apparel, Building/Building Materials, and Financial Services added value. Security selection within commodity-oriented industries, such as Energy and Metals/Mining, as well as within Utilities and Technology, also contributed. Other than cash drag, the main detractor was security selection within Telecommunications. Bond yield curve positioning added some value as US Treasury rates continued to flatten, but for accounts with a loan allocation, senior floating rate loans underperformed the

bond rally in 3Q.

Ultra Short Duration Corporate Income

Our Ultra Short Duration Corporate Income strategy, which owns only paper maturing in three years or less, outperformed the ICE BofA Merrill Lynch 1-3 Year US Corp/Government Index in 3Q. Our strategy of mainly BB-rated sub-investment grade holdings, which include corporate bonds and loans, outperformed short-term Treasuries amid a strong bid for credit. The strategy benefitted from its exposure within Healthcare, Financial Services, Telecommunications, and Media/Broadcasting. The Printing/Publishing sector was weaker on organic growth fears despite strong cash flows. B-rated bonds outperformed both BB-rated and BBB-rated bonds within the strategy. For accounts with a loan allocation, senior floating rate loans under three years to maturity outperformed the Index although they trailed the bond rally. Looking forward, we expect capital markets to remain open to high quality sub-investment grade companies; during 2018 our short duration portfolios continued to benefit from positive catalysts including over a dozen refinancings and multiple equity issuances.

Defensive Short Duration High Income

Our Defensive Short Duration High Income strategy, which maintains an average portfolio

maturity of three years or less, underperformed the ICE BofA Merrill Lynch 1-3 Year BB-B Cash Pay High Yield Index in 3Q but outperformed the BB-version of the Index. An underweight position and strong security selection within the Retail/Apparel and Building/Building Materials added value. Security selection contributed within Services and Media/Broadcasting sectors, but detracted within Gaming and Financial Services. B-rated bonds outperformed both BB-rated and BBB-rated bonds within the strategy. For accounts with a loan allocation, senior floating rate loans outperformed short duration bonds as LIBOR inched higher late in the quarter. Looking forward, we expect capital markets to remain open to high quality sub-investment grade companies; during 2018 our short duration portfolios continued to benefit from positive catalysts including over a dozen refinancings and multiple equity issuances.

Defensive Floating Rate Income

The Defensive Floating Rate Income strategy outperformed its broader loan Index in 3Q, as well as the S&P/LSTA BB-Rated Index, bolstered by an allocation to high yield bonds which rallied late in the period. The top performing loan position during 3Q was a privately held restaurant company that currently is in the process of being sold. We

expect the sale proceeds to repay lenders within the next 12 months. Another contributor was a start-up steel flex mill that reported strong results in its first several quarters of operation. Fundamentals were helped by recent steel tariffs and the subsequent rise in domestic steel prices. The strategy's worst performing position was an investment in a software company focused on data protection. The company reported weaker than expected results and we exited the loan in accordance with our sell discipline. An investment in a telecom issuer also underperformed for the quarter.

We believe conditions in the syndicated loan market remain favorable. Through September, YTD gross new loan issuance fell -18% versus last year but coincidentally rose +18% on a net basis as issuers took advantage of favorable borrowing conditions in the loan market. Retail inflows (\$16b) and collateralized loan obligations formation (\$105b) generated more than adequate demand to absorb the new supply; at the end of 3Q, 65% of the syndicated loan market was quoted above par, up from 24% at the end of 2Q 2018. Loan returns also benefitted from a continued rise in LIBOR, which rose 106 basis points over the last 12 months. Our strategy is positioned with a higher quality bias and remains underweight B-rated credits and avoids

loans CCC-rated or containing junior liens. In 3Q, the strategy held a 14% position in high quality corporate bonds to bolster liquidity. We continue to be very selective in how we participate in the primary market. Our capacity constraints and focus on quality prevent us from being forced buyers as new deals come to market. Given the expectations for further rate increases for the remainder of 2018, we continue to believe loans remain an attractive opportunity for investors, particularly compared to other high-quality fixed income asset classes.

Outlook

We remain optimistic on the US economy and corporate creditworthiness. The US HY and loan last-twelve-month bond default rate is now in the process of falling below 2%. We continue to forecast a relatively low default rate and expect M&A activity to benefit small-cap oriented asset classes like HY. Generally, we expect fundamentals for HY companies, most of which are US-centric, non-global-traders, to remain relatively healthy, and we expect commodity-industry defaults to remain below historical HY averages.

HY indices returned a rare coupon-like 7% in 2017, in line with our estimates. We expect the remainder of 2018 to be positive, but less than 2017, with the main variable being the direction of interest rates.

Significantly higher interest rates across the US Treasury curve would negatively impact HY market return expectations, however we would expect the asset class to outperform higher quality fixed-rate strategies as it has during past interest rate hike cycles. To the extent that long-term interest rates will rise in a growing economy, we believe that larger-cap dividend paying equities and longer duration fixed income asset classes, including investment grade corporates, may underperform as a result. We continue to favor the loan asset class as a bond complement, particularly for more conservative investors that desire floating rate exposure, and have been increasing our allocation gradually over the last several years for those clients with loans in their portfolio.

Please remember that past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product (including the investments and/or investment strategies recommended or undertaken by Penn Capital), or any non-investment related content, made reference to directly or indirectly contained within this commentary be suitable for your portfolio or individual situation, or prove successful. Comparisons to indices are inherently unreliable indicators of future performance. The strategies used to generate the performance vary from those used to generate the returns depicted in the benchmarks. Penn Capital makes no representation as to the methodology used to generate the benchmark returns.

The ICE BofA Merrill Lynch 1-3 Year US Corporate & Government Index is a subset of the ICE BofA Merrill Lynch US Corporate Master Index tracking the performance of US dollar denominated investment grade rated corporate debt publicly issued in the US domestic market. This subset includes all securities with a remaining term to final maturity of less than three years. An investor cannot directly invest in an index. The ICE BofA ML US HY Cash Pay BB-B Rated 1-3 Year Index is a subset of The ICE 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. An investor cannot directly invest in an index. The ICE BofA Merrill Lynch US High Yield Constrained Index contains all securities in The ICE BofA Merrill Lynch US High Yield Index but caps issuer exposure at 2%. An investor cannot directly invest in an index. The ICE BofA Merrill Lynch BB-B Rated Non-Distressed Index is a subset of The ICE BofA Merrill Lynch US High Yield Index including all securities rated BB1 through B3, inclusive, with an option-adjusted spread less than 1,000 basis points. The Credit Suisse Institutional Leveraged Loan Index is a sub-index of the Credit Suisse Leveraged Loan Index. The Credit Suisse Leveraged Loan Index is designed to mirror the investable universe of the \$US-denominated leveraged loan market. The Credit Suisse Institutional Leveraged Loan Index is designed to more closely reflect the investment criteria of institutional investors by sampling a lower volatility component of the market. An investor cannot directly invest in an index.

A copy of Penn Capital's current written disclosure statement discussing our advisory services and fees is available upon request.

Specialists in capital structure investing

At Penn Capital, we believe that understanding a company's entire capital structure is the best way to identify investment opportunities with the most value. In fact, we've found that managing bond portfolios makes us better equity managers, and vice versa. Employing a fully integrated credit and equity research process, we focus on non-investment grade companies in the micro to mid-capitalization range, where we can take advantage of inefficient security pricing. We are an independent, employee-owned boutique based in Philadelphia. We forge our own ideas, we respect hard work, and we are committed to our clients, our staff and our community.

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