Strategic Income Management

Value Driven, Income Focused

SiM on High Yield Investing

2023

Myths & Facts: Misconceptions

- **Illiquid/Opaque market**
- **Struggling companies**
- **High risk** of default
- **Lack of diversity** in industry and company size
- Highly **sensitive to** moves in **interest rates**
- Ever present **maturity wall** threat
- **ETFs a structural liquidity concern** and can cause havoc during next downturn

High Yield Investing

Equity like returns, half the risk

Myths & Facts: Reality

- **$1.7 Trillion** in US issued high yield bonds, **4%** of **U.S. fixed income market**
- **1/20** the size of **US equity market**
- **1800+** US listed High Yield **Issues**;
- **80%** of high yield bond issuers with **equity outstanding have market capital >$1 Billion**
- **Small size** often **equates** to **lower rating**
- **Average default rate** over previous 25 years is roughly **3%** with **40% recovery**
- **70%+** of high yield bonds are issued by **public companies**
- **Low correlation** to most asset classes
- **Very diverse** across industries and company size

High Yield Investing

Equity like returns, half the risk

Ideal diversifier: Low Correlation

- Low correlation to most asset classes over past 25 years thru 12/2022

Risk and returns of various assets

Twenty five-year correlation ended November 30, 2022

	5-year Treasury	10-year Treasury	LB Aggregate Bond Index	Investment-grade bonds	High-yield bonds	S&P 500	Wilshire 5000	Russell 2000	Gold	US Inflation
10-year Treasury	0.93									
LB Aggregate Bond Index	0.83	0.87								
Investment-grade bonds	0.56	0.63	0.87							
High-yield bonds	**-0.17**	**-0.15**	**0.23**	**0.54**						
S&P 500	-0.26	-0.23	0.04	0.29	**0.67**					
Wilshire 5000	-0.26	-0.24	0.05	0.29	**0.69**	0.99				
Russell 2000	-0.29	-0.28	-0.01	0.24	**0.68**	0.84	0.89			
Gold	0.29	0.28	0.32	0.31	**0.14**	0.05	0.07	0.07		
US Inflation	-0.24	-0.26	-0.24	-0.21	**0.07**	0.02	0.02	0.02	0.03	
Leveraged loans	**-0.33**	**-0.33**	**0.03**	**0.33**	**0.82**	**0.51**	**0.52**	**0.53**	**0.03**	**0.21**

Sources: J.P. Morgan; Bloomberg Finance L.P.

- Historically lower correlations during market downturns

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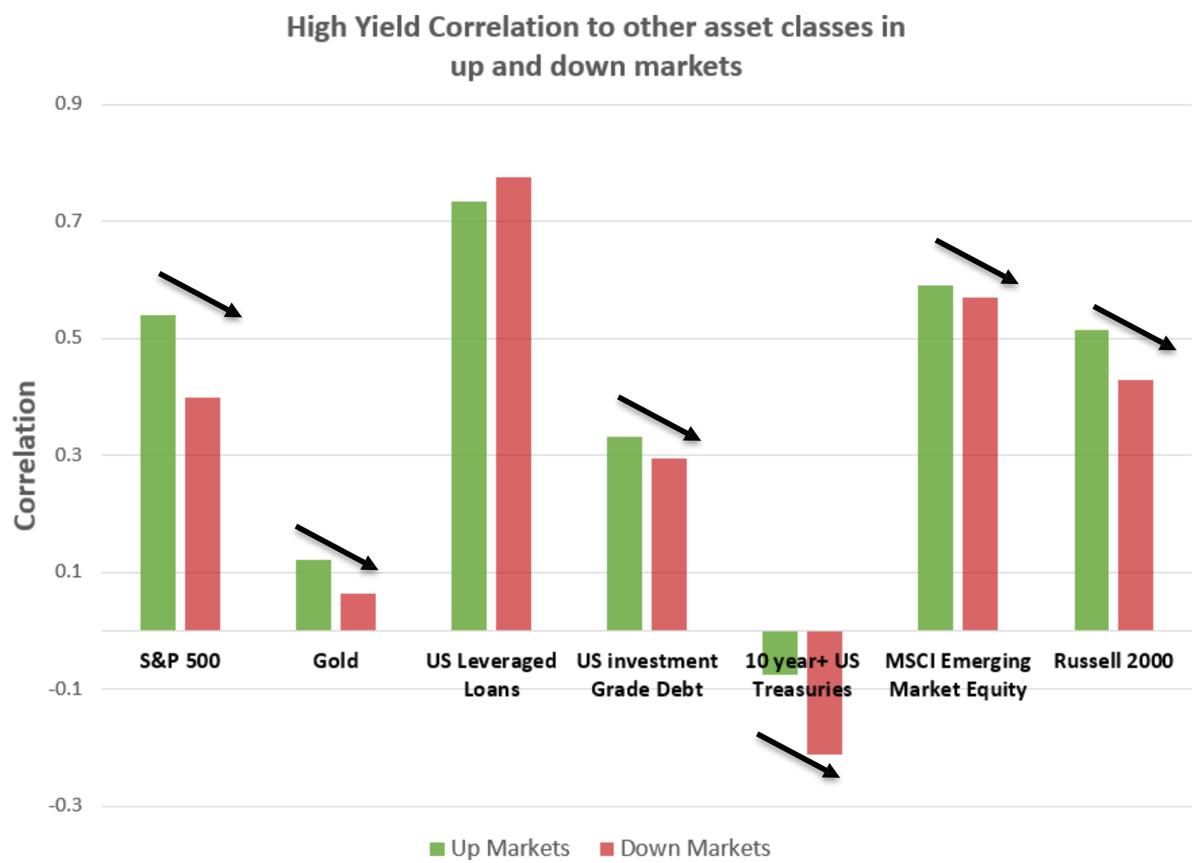
Equity like returns, half the risk

Ideal diversifier: Correlations drop during down markets



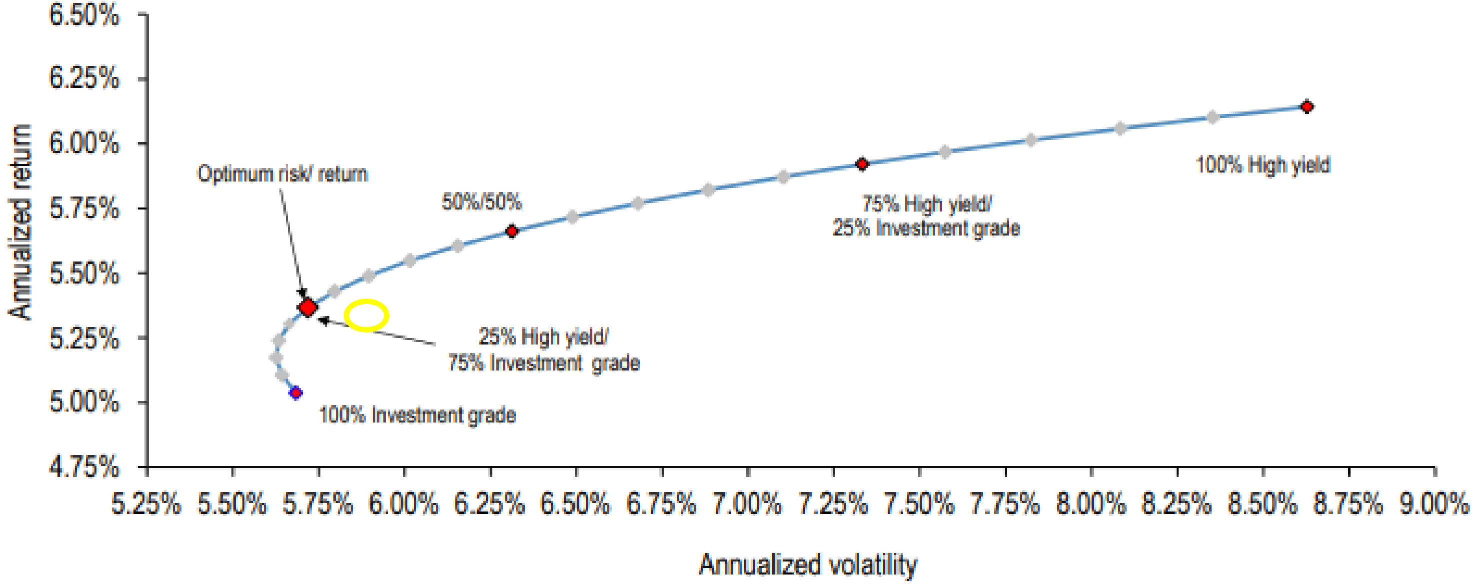
**Down markets include: 8/31/2000-10/9/2002; 10/10/2007-03/07/2009; 7/20/2011-9/30/2011; 8/17/2015-2/10/2016*
**Up markets include: 10/10/2002-10/10/2007; 37/2009-7/20/2011; 9/30/2011-8/17/2015; 2/10/2016-7/31/2018*

High-Yield bonds diversification in action

(Statistics over past 25 years as of November 2022)

Figure 16: Risk/return trade-off

(investment-grade vs high-yield bonds: 25 years ended November 30th, 2022)



Source: J.P. Morgan.

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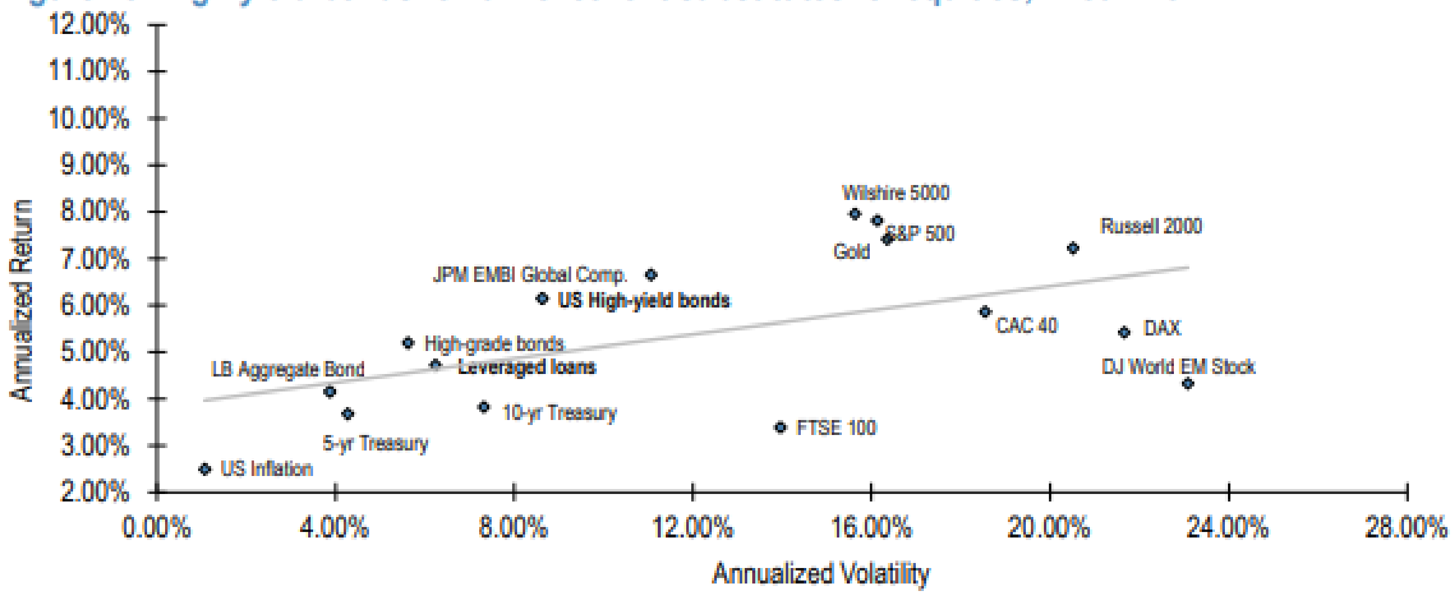
Equity like returns, half the risk

Ideal Diversifier: High Return/Low Risk

- High Return/Low Risk characteristics Last 25 years as of 11/2022

Figure 15: High-yield bonds remain excellent substitutes for equities, in our view



Source: J.P. Morgan.

High Yield Investing

Equity like returns, half the risk

Ideal Diversifier: Recession resilience

Drawdowns over past 40 years

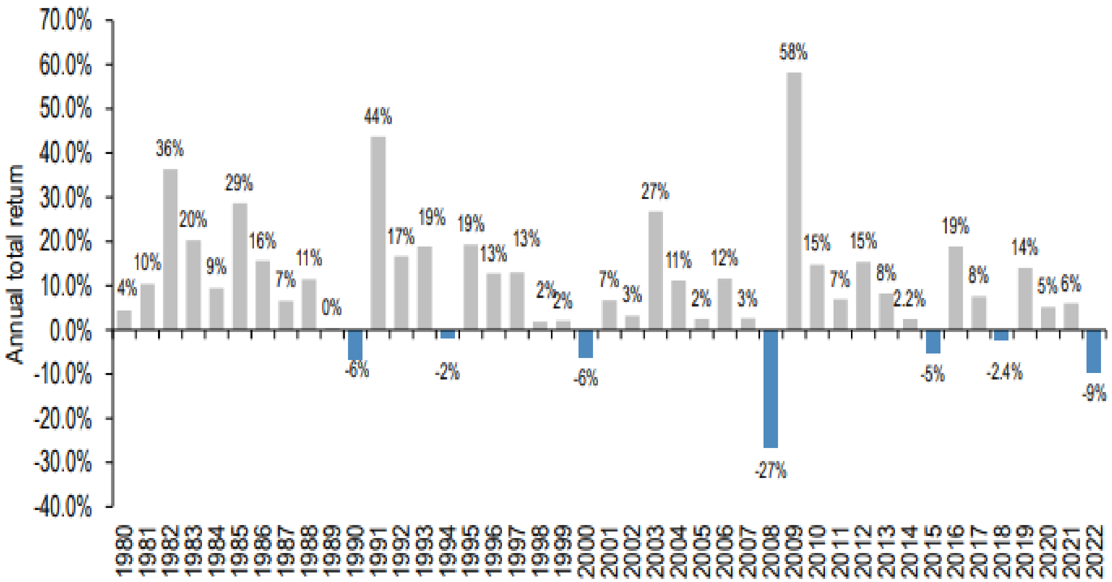
S&P 500

- 9 down years
- 4 years 10% or greater loss
- Tech Bubble ~6yrs to recover
- GFC ~4.5yrs to recover

High Yield Bonds

- 6 down years
- 1 year 10% or greater loss
- Tech Bubble ~2yrs to recover
- GFC ~2yrs to recover

Figure 14: Including 2022, high-yield bonds have only posted seven losses in 40yrs



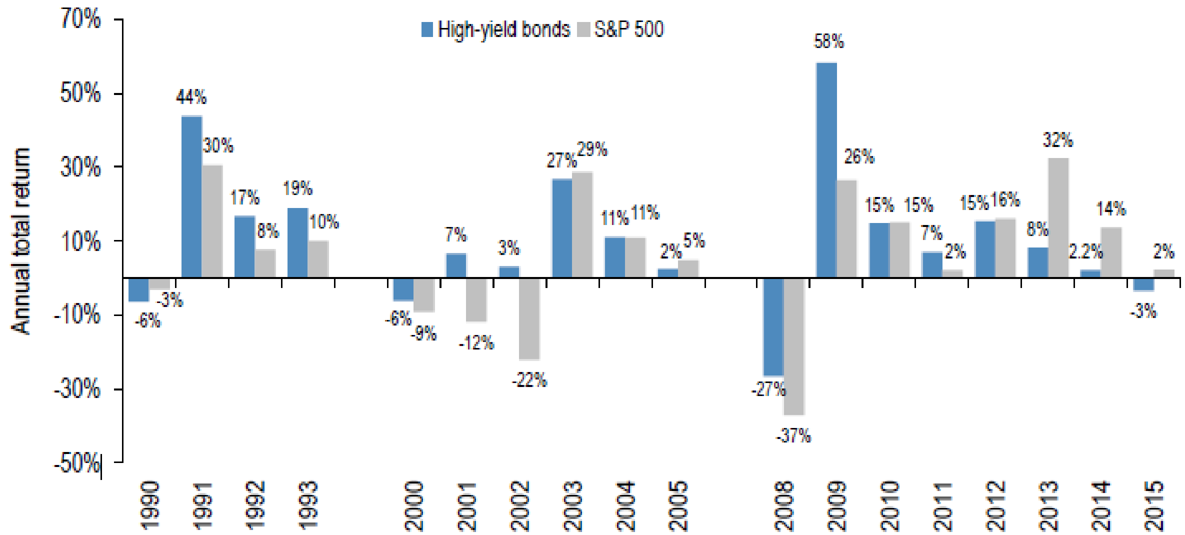
Source: J.P. Morgan.

High Yield Investing

Equity like returns, half the risk

Ideal Diversifier: Recession resilience

Figure 11: High-yield bond versus equity performance during and emerging from recessions



Source: J.P. Morgan.

- High-Yield bonds have outperformed equities during down years, while exhibiting equal or greater performance in the years leading out of a recession.

Why High Yield Bonds are an ideal diversifier?

- **Low correlation** to other asset classes, especially during sell-offs.
- **High return/Low risk** (only 7 down years in past 40 years).
- **More recession resilient than equities.**
- **extremely high returns exiting recessions**.

Active over Passive: HY Index is hard to replicate

- **Expensive to trade**, wide bid-ask spreads hinder rebalancing efforts.
- **Hard to trade** in small lot sizes (under $100,000 is considered an odd lot in high yield and will require a discount in most cases).
- **Tightly held** issues are difficult to purchase and hard to move in and out of.
- ICE BofAML US High Yield Index has **2,000 issues** forcing passive managers to purchase only a portion of the index.
- **Passive approaches** can **bring unintended exposures**, such as increased rate sensitivity or exposure to the most indebted companies.

Active over Passive: Inefficiencies and market structure provide perfect recipe for active management

Inefficiency example:

- **Small companies pay you more** on a like for like basis (same rating and credit matrix) earn ~100 basis points more in current yield.

Market Structure examples:

- **The equation is simplified,** cashflow cashflow cashflow
- **Get paid to wait**, over the past 15 years income return has accounted for 7% annualized return on the BAML High Yield Index
- **Imbedded catalyst,** maturity date

What gives a value investor confidence that value will be unlocked?...A catalyst.

Liquidity, better than most: Transaction volume doesn’t equal liquidity

- Third Avenue Focused Credit wasn’t high yield, it was distressed.
- During 2008, high yield bonds outperformed equities “more liquid” and bank loans “safer”.
- Transaction volume on NYSE peaked in 2008, transaction volume doesn’t equal liquidity.
- Often the tightest held and least traded high yield bonds are the most desirable and easiest to sell.

Illiquidity is created by opaque, dark and or complex markets.

High Yield Investing

Equity like returns, half the risk

Liquidity, better than most: You know high yield companies better than you think

- ~80% of high yield bond issuers with equity outstanding have market capital >$1 Billion
- ~70%+ of high yield companies by issuer are public companies
- Trades in all US listed high yield companies are reported to a public exchange TRACE

Least Liquid **Most Liquid**

SiM and High Yield Today

3/31/2023

Characteristics Summary		
	SiM	HY Index*
Price	89.2	90.2
Yield To Worst	8.1%	8.4%
Option Adjusted Spread	445	445
Coupon	5.2%	5.8%
Rating	B+	B+
Current Yield	5.9%	6.6%
Yield To Maturity	8.2%	8.6%
Effective Duration	3.8	3.8

CORE: 61% **Out Of Favor: 39%**

High Yield Investing

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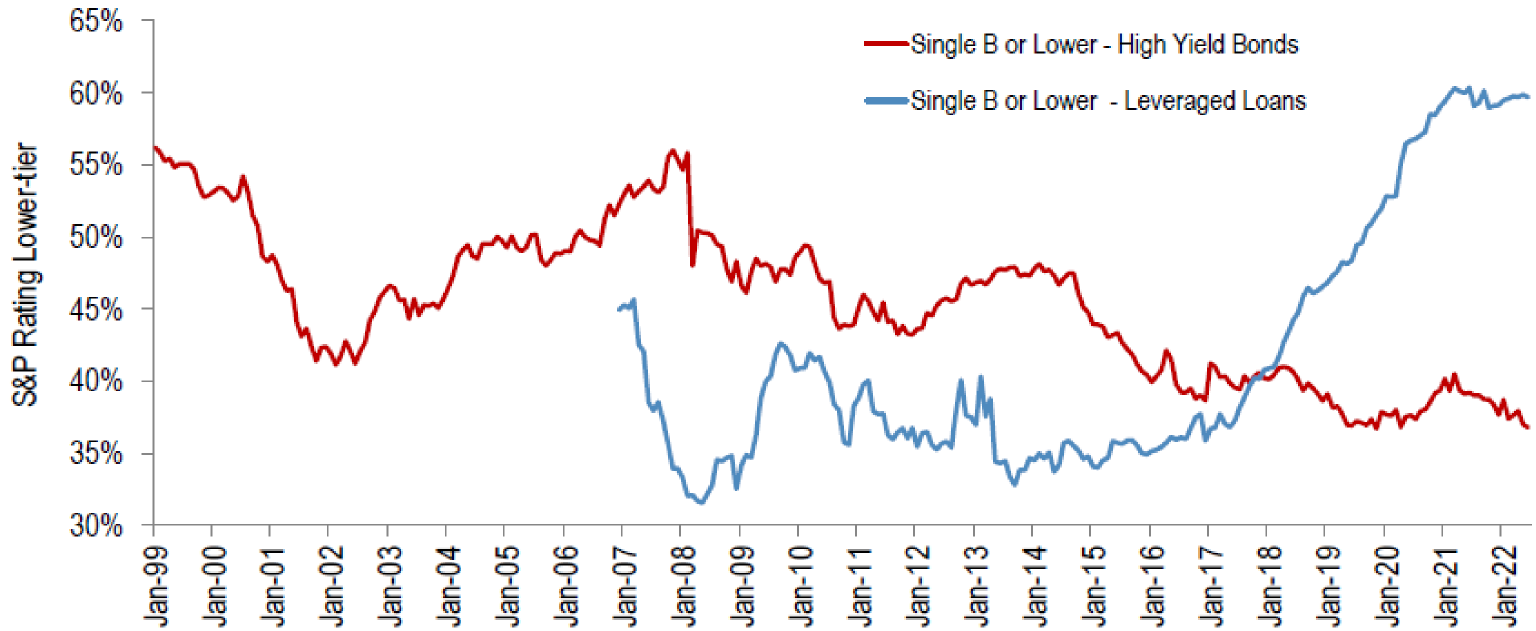
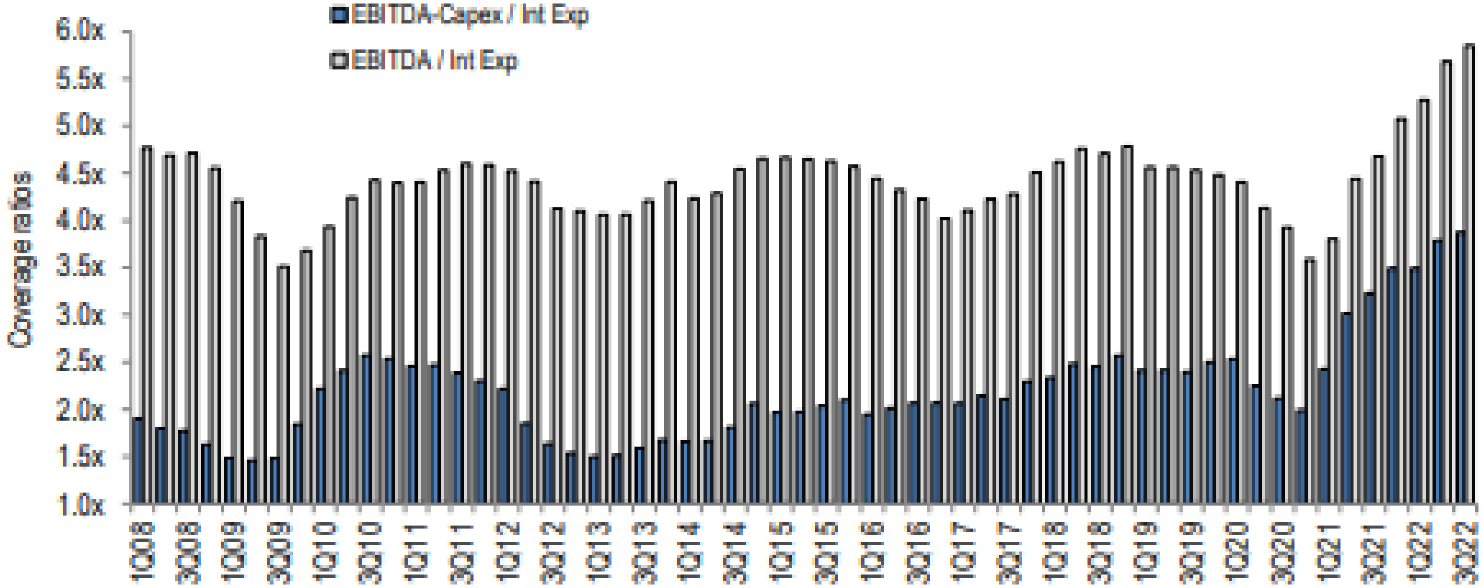
High-Yield Bonds have Structurally Improved over Time Vs. Loans



Source: J.P. Morgan.

High-Yield Bonds are very strong structural

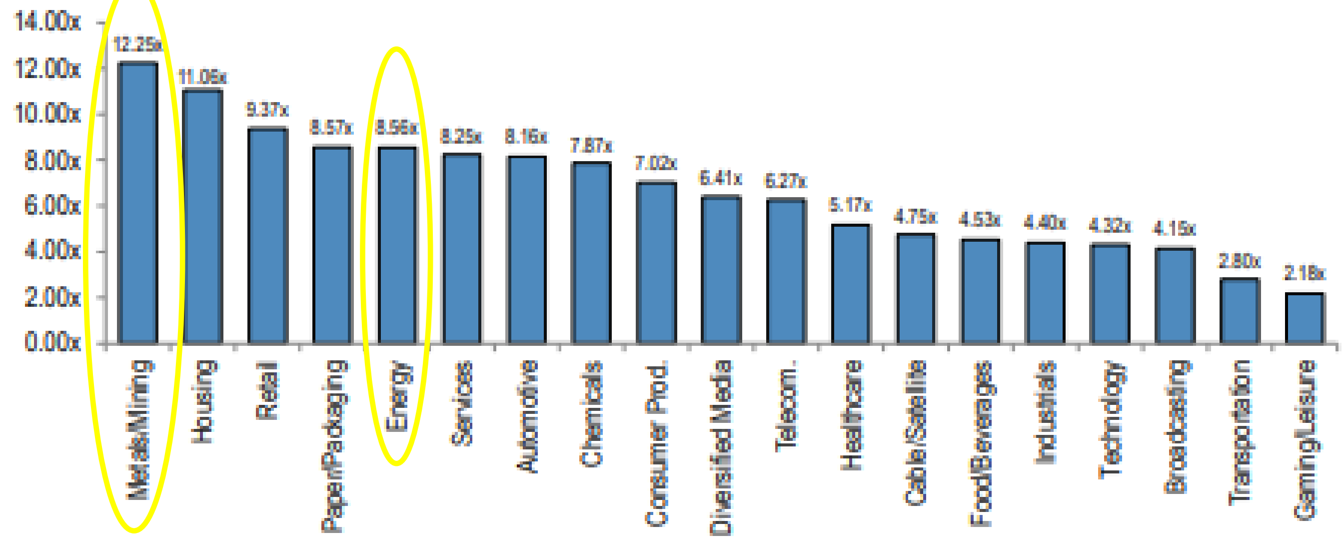
Figure 10: Coverage ratio increased to a record high in a fourth consecutive quarter



Sources: J.P. Morgan; Capital IQ.

High-Yield Bonds are very strong structural

Figure 12: Coverage by industry



Sources: J.P. Morgan; Capital IQ.

Section Seven:

Opportunities in High Yield Today

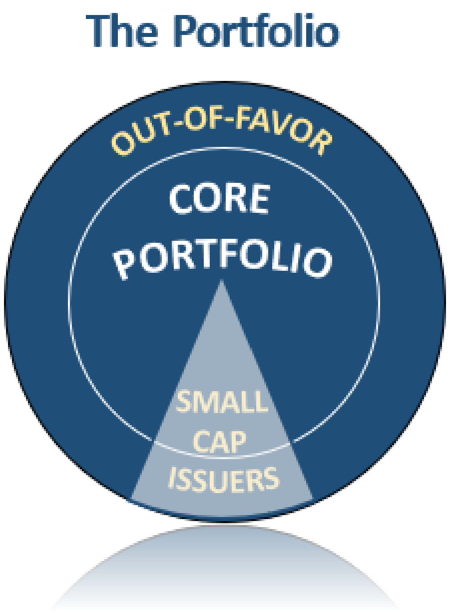
High Yield Investing

Equity like returns, half the risk

Principle One:
Identify long term trends and themes

Principle Two:
Focus on the right Industries

Principle Three:
Analyze as a CFO/Owner



High Yield Investing

Equity like returns, half the risk

Opportunities in Core Industries

(Long-Term)

- Defense
- Healthcare
- Consumer Goods

Opportunities in Out-of-Favor Industries

(Medium-term)

- Real Estate
- Leisure

The Portfolio

Conclusion

- High yield is an **excellent diversifier** and an asset class that should always be in your portfolio.
- The return in high yield is **equity like** while taking substantially **less risk**.
- **Active management** can add value in High Yield due to the market structure and inefficiencies.
- For 20+ years **SiM** has consistently provided clients with excess returns over the US ICE/BAML High yield Index at a lower per unit risk