

FIRST STATE INVESTMENTS HIGH YIELD

Quarterly Update

High Yield
Q1 2020

Executive Summary

The first quarter was extreme in the scale and magnitude of financial market volatility, particularly over the last six weeks of Q120. A dramatic, global economic slowdown resulted from the unprecedented global quarantine of entire populations, in most developed countries, in response to the COVID-19 disease, which is widely deemed a deadly, viral pandemic. Global markets sold off in an apparent accelerating meltdown between 20 February and 23 March, only to stabilise, and then recover smartly from their lows after unprecedented monetary and fiscal stimulus measures were announced. Overall, the High Yield market, as represented by the ICE BofA US High Yield Constrained Index (HUCO), was down -13.13% during Q120 and the S&P 500 Index sold off -19.60%. Over the same period, 10-Year US Treasuries returned +11.93% as the Federal Reserve slashed interest rates and reflected a 'flight to quality' as investors reset their growth forecasts.

Returns (gross) from the First State Investments High Yield strategy over the period were directionally consistent with expectations, while price dislocations remained widespread as the quarter ended in the midst of extreme market volatility. The Broad High Yield strategy returned -11.18%, outperforming by 195 bps. Over the trailing 12 month period the Broad strategy returned -4.07%, outperforming by 339 bps. The Quality and Short Duration strategies returned -10.45% and -8.58%, outperforming their benchmark indices by 148 & 338 bps for the quarter, respectively. The Select strategy returned -12.49%, outperforming by 64 bps.

High yield spreads and yields finished the quarter at 875 bps and 9.25%, which was 503 bps and 3.84% wider for the quarter, respectively. Fund flows reversed course during the quarter; we saw \$16.7 billion and \$11.6 billion of outflows in the High Yield and Leveraged Loan markets, respectively. In similar fashion with the overall market, the new issue calendar dried up almost entirely in March. Just one deal – Yum! Brands – was completed after the first three business days of the month.

Within the High Yield index, the main performance outliers by sector were Airlines and Energy to the downside and Food & Drug Retail and Cable TV to the upside. As investors favoured higher quality issuers, CCCs led the underperformers and BBs outperformed Bs.

High Yield Composite Performance - Annualised

As of 31 March 2020	Inception 30 April 2017						
	Q120	6M	1 year	2 year	Since Inception (Annualised)	2019	2018
Broad High Yield	-11.18%	-8.76%	-4.07%	0.81%	1.90%	16.09%	-1.62%
ICE BofAML US HY Const Idx	-13.13%	-10.87%	-7.46%	-0.99%	0.18%	14.41%	-2.27%
Active Performance	1.95%	2.10%	3.39%	1.80%	1.73%	1.68%	0.65%
Select High Yield	-12.49%	-10.05%	-5.44%	-0.08%	1.36%	16.55%	-2.06%
ICE BofAML US HY Const Idx	-13.13%	-10.87%	-7.46%	-0.99%	0.18%	14.41%	-2.27%
Active Performance	0.64%	0.81%	2.02%	0.91%	1.18%	2.14%	0.21%
Quality High Yield	-10.45%	-8.05%	-3.31%	1.26%	2.19%	15.75%	-1.34%
ICE BofAML BB-B US HY Constr Idx	-11.93%	-9.66%	-5.56%	0.21%	0.88%	15.10%	-2.04%
Active Performance	1.48%	1.62%	2.25%	1.06%	1.30%	0.64%	0.71%
Short Duration High Yield	-8.58%	-6.64%	-3.69%	0.73%	1.59%	10.84%	0.53%
ICE BAM 1-5 YR BB-B US Cash Pay HY Idx	-11.96%	-10.16%	-7.37%	-0.89%	0.32%	10.98%	0.67%
Active Performance	3.38%	3.52%	3.68%	1.63%	1.27%	-0.14%	-0.15%

First State Investments as at 31 March 2020. The Inception Date of the FSI High Yield Composites was May 1, 2017. Past performance is not a reliable indicator of future performance. The assets within the FSI Select High Yield Composite and the FSI Quality High Yield Composite have been combined to create the FSI Broad High Yield Composite. Composite returns are gross of fees in USD. Performance figures do not reflect the deduction of investment advisory fees, commissions and other charges. Note: due to rounding percentages may not precisely reflect the absolute figures.

RISK FACTORS

This document is a financial promotion for The First State High Yield Strategy. This information is for professional clients only in the EEA and elsewhere where lawful. Investing involves certain risks including:

- **The value of investments and any income from them may go down as well as up and are not guaranteed. Investors may get back significantly less than the original amount invested.**
- **Currency risk:** Changes in exchange rates will affect the value of assets which are denominated in other currencies.
- **Credit risk:** The issuers of bonds or similar investments may not pay income or repay capital when due.
- **Interest rate risk:** Interest rates affect the value of investments; if rates go up, the value of investments fall and vice versa.
- **Below investment grade risk:** Below investment grade debt securities are speculative and involve a greater risk of default and price changes than investment grade debt securities due to changes in the issuer's creditworthiness. In periods of general economic difficulty, the market prices may fluctuate and decline significantly.

Reference to specific securities or companies (if any) are included to explain the investment strategy and should not be construed as investment advice, or a recommendation to invest in any of those companies.

There are currently no investment funds available for this strategy in the EEA. Please contact your sales representative for more details.

If you are in any doubt as to the suitability of our funds for your investment needs, please seek investment advice.

High Yield Net Performance - Annualised

As of 31 March 2020							Inception 30 April 2017			
	Q120	6M	1 year	2 year	Since Inception (Annualised)	2019	2018	12 mths to 31/03/2020	12 mths to 31/03/2019	
Broad High Yield	-11.27%	-8.95%	-4.45%	0.40%	1.50%	15.63%	-2.01%	-4.45%	5.51%	
ICE BofAML US HY Const Idx	-13.13%	-10.87%	-7.46%	-0.99%	0.18%	14.41%	-2.27%	-7.46%	5.93%	
ActivePerformance	1.87%	1.92%	3.01%	1.40%	1.32%	1.22%	0.25%	3.01%	-0.42%	
Select High Yield	-12.58%	-10.23%	-5.82%	-0.48%	0.95%	16.08%	-2.45%	-5.82%	5.16%	
ICE BofAML US HY Const Idx	-13.13%	-10.87%	-7.46%	-0.99%	0.18%	14.41%	-2.27%	-7.46%	5.93%	
ActivePerformance	0.55%	0.63%	1.64%	0.51%	0.78%	1.67%	-0.18%	1.64%	-0.77%	
Quality High Yield	-10.54%	-8.23%	-3.70%	0.86%	1.78%	15.28%	-1.73%	-3.70%	5.63%	
ICE BofAML BB-B US HY Constr Idx	-11.93%	-9.66%	-5.56%	0.21%	0.88%	15.10%	-2.04%	-5.56%	6.33%	
ActivePerformance	1.40%	1.43%	1.87%	0.65%	0.90%	0.18%	0.31%	1.87%	-0.70%	
Short Duration High Yield	-8.67%	-6.83%	-4.07%	0.33%	1.18%	10.40%	0.13%	-4.07%	4.94%	
ICE BAM 1-5 YR BB-B US Cash Pay HY Idx	-11.96%	-10.16%	-7.37%	-0.89%	0.32%	10.98%	0.67%	-7.37%	6.04%	
ActivePerformance	3.29%	3.34%	3.30%	1.22%	0.87%	-0.58%	-0.55%	3.30%	-1.10%	

First State Investments as at 31 March 2020. Composite inception date is 1 May 2017. Shown as net of fees in USD, deducting institutional share class fees (AMC: 0.40%). The assets within the FSI Select High Yield Composite and the FSI Quality High Yield Composite have been combined to create the FSI Broad High Yield Composite. These figures refer to the past. Past performance is not a reliable indicator of future results.

Market review

Global markets began to sell-off in February, initially in credit and emerging market equities. By way of context, the World Health Organization declared a global public-health emergency due to COVID-19, on 30 January; followed by the declaration of a U.S. national emergency, on 13 March. As a result of unprecedented global health measures, developed market equities sold off precipitously over a 4 week period beginning in the second half of February: the S&P 500 -34%, NASDAQ Composite -43%, STOXX Europe 600 -36% and Nikkei 225 -29%. The global outbreak of the COVID-19 coronavirus became widely viewed as a deadly, global pandemic, resulting in unprecedented global quarantine restrictions, from Asia, to Europe, and the US. The inevitable result has been an unprecedented global economic slowdown/shutdown. Early indications of how unprecedented include 4 week initial jobless claims in excess of +20 mm, increasing the unemployment rate from 1.2%, to at least 17%. In addition, many economists now forecast that Q220 GDP is set to decline in excess of -30%.

The COVID-19 global pandemic, and the resultant, collapse in global economic activity arrived with the Fed already dealing with liquidity challenges in the massive, global overnight lending (repo) markets; while global debt, both public and private, stood at all-time, record highs.

In necessary response, the Federal Reserve provided record monetary stimulus and support to the financial markets. Key highlights: on Sunday, 16 March, the Fed lowered the federal fund rate to 0 percent, and also announced a new round of QE: "at least" \$700 billion in assets over the coming months, with no limit. On 23 March, the Fed announced a myriad of additional measures that defined its own "whatever it takes" moment.

Unprecedented fiscal stimulus followed on 27 March, when President Trump signed into law the \$2.2 trillion Coronavirus Aid, Relief, and Economic Security (CARES) Act. The largest economic stimulus package in U.S. history was drafted, unanimously approved by Congress and signed into law, in less than two weeks. The Fed will be effectively tasked with funding these massive "relief" programs, making unlimited QE a particularly timely policy stance.

The record central bank monetary stimulus, in tandem with the record fiscal spending bill succeeded in stabilizing global financial markets which have now rallied strongly from their March-lows. However, economic uncertainty remains high in truly uncharted territory.

In our opinion, investment opportunities abound, at the same time future volatility risk remains high, albeit temporarily appearing dormant.

The US High Yield market, as represented by the ICE BofAML US High Yield Constrained Index (HUCO) witnessed one of the worst quarters in history, posting a -13.13% return. This dragged returns down to -7.46% on a rolling 12-month basis. As at quarter end, the spread and yield of the US High Yield Market was 875 bps, and 9.25%, which represent moves of 503 bps, and 3.84% over the quarter, respectively. For context, previous peaks in spreads during periods of extreme market volatility include, 888 bps (Feb '16), 885 bps (Oct '11), 2069 bps (Dec '08), and 1116 bps (Oct '02). Default rates are currently at three-year highs, though at 3.54%, still appear somewhat subdued given spread movements over the quarter.

	Q120*	Q419*
Yield-to-Worst	9.25%	5.41%
Spread-to-Worst (bps)	+875	+372
Duration-to-Worst	4.30	3.03
Average price	\$85.79	\$100.74

*BAMM US High Yield Constrained Index

Within the High Yield index, the best performing sector was Food & Drug Retail (-2.79%), which was supported by consumers' need for household amenities and food as social distancing and shelter in place policies pulled forward demand.

The worst performing sector was Energy (-39.70%), which fell sharply as commodity prices were hammered and as the outlook for global GDP growth deteriorated. Oil prices dropped 66% over the quarter, driven by lower demand as COVID-19 concerns mounted and an increase in supply as Saudi Arabia ramped up production. This is a price point below where many exploration & production companies are profitable. The long-term impact will be determined (in part) on the speed and magnitude of an economic recovery. Our focus remains on firms that fit our 'margin of safety' requirements and which can withstand a prolonged crisis, in our view.

Airlines (-25.31%), also struggled during the quarter, reflecting sharp declines in passenger volumes due to international and domestic travel restrictions. TSA data is showing a >90% drop in US air passengers.

The Leveraged Loan market was off -13.00% during the quarter, with more pronounced price volatility in March than the US High Yield market. This primarily reflected concerns about excesses that had built up in the loan market and panic selling across ETFs and mutual funds.

From a credit quality perspective, CCCs led the way lower, down -21.74%. In fact, downward price pressure was substantial across the full High Yield credit spectrum; Bs were down -14.73% and BBs -10.57%.

Lastly, a wave of Investment Grade downgrades following the build-up in BBB credit over the last five years appears to have started, with two huge issuers joining the High Yield market; Ford and Occidental Petroleum (Join HUCO at the end of April). We expect this trend to continue as rating agencies catch up to the reality of the fundamentals. That said, we do see value in some BBB names and will continue to watch to see if and when these issues fit our investment process and offer relative value.

Exhibit 1: Returns of Various Assets

Asset Class	Q120	CY 2019	Q419	Q319	Q219	Q119	CY 2018
S&P 500	-19.60%	31.48%	9.06%	1.70%	4.30%	13.65%	-4.39%
Emerging Market Stocks	-23.60%	18.63%	11.74%	-4.13%	0.73%	9.94%	-14.28%
10-Year US Treasury	11.93%	8.91%	-1.77%	3.18%	4.23%	3.10%	-0.03%
Investment Grade Corp	-4.05%	14.23%	1.15%	3.07%	4.35%	5.01%	-2.25%
US High Yield Corp Bonds	-13.13%	14.41%	2.61%	1.22%	2.57%	7.40%	-2.27%
Leveraged Loans	-13.00%	8.64%	1.85%	1.03%	1.63%	3.89%	1.08%
Euro High Yield Corps	-14.63%	11.29%	1.98%	1.30%	2.33%	5.28%	-3.63%
EM High Yield Corps	-14.53%	13.49%	4.15%	-0.27%	3.08%	5.98%	-2.29%
US High Yield by Rating							
BB US High Yield Corps	-10.57%	15.74%	2.39%	2.05%	3.17%	7.36%	-2.57%
B US High Yield Corps	-14.73%	14.26%	2.89%	1.11%	2.31%	7.35%	-1.72%
CCC US High Yield Corps	-21.74%	9.56%	3.43%	-2.38%	0.58%	7.89%	-4.91%

Indices are gross of fees

Strategy review

The Broad High Yield strategy returned gross -11.18% in Q120, gross 195 bps ahead of its benchmark index. For the trailing 12 months, the Broad strategy returned -4.07%, 339 bps ahead of its benchmark index.

The top three contributors to outperformance at the sector level were, Energy, Telecommunications, and Healthcare. The bottom three sector contributors to outperformance were Media, Utilities and Technology.

Strong security selection drove performance. Sprint, Delphi and Freeport-McMoran were the top three contributors at the issuer level.

- **Sprint Corp (S):** Sprint bonds outperformed in the quarter following Sprint and T-Mobile's win in the Southern District of NY over a group of State AGs attempting to block their merger. The acquisition by higher quality T-Mobile results in a larger, more competitive wireless competitor with healthy free cash flow generation and a stronger balance sheet than standalone Sprint. The combined company is well capitalized to build out a 5G network and compete with larger players Verizon and AT&T.
- **Delphi (DLPH):** Delphi bonds outperformed in the quarter due to the announcement in January that the company agreed to be acquired by BorgWarner (BWA). BWA is an investment grade company, and the bonds moved strongly higher due to the likelihood of BWA repaying the bonds shortly after the deal closing. Shortly thereafter, we took the opportunity to sell the bonds.
- **Freeport-Mcmoran (FCX):** Freeport unsecured bonds were added to our portfolios after significant price weakness during the first 3 weeks of March. The notes then rallied sharply into quarter-end, but price volatility may remain elevated. Importantly, FCX is the world's second largest copper producer, with an attractive cost position that results in asset coverage in excess of 2X at the unsecured bond level. The company faces the challenging macro environment, ahead, in a strengthened position relative to 2015/16: gross debt reduced by \$11 billion since year-end 2015, debt maturities proactively extended, and current liquidity of \$5 billion includes \$2 billion in cash.

The bottom three contributors were Crestwood Midstream, Hess Midstream and Magnolia Oil and Gas. While Energy provided the bottom three contributors at the issuer level, the sector as a whole was the biggest contributor to alpha due to strong overall security selection.

- **Crestwood Midstream (CMLP):** Crestwood traded down this quarter with the broader midstream gathering and processing (G&P) sector as US production growth expectations declined rapidly amidst aggressive capital spending cuts by exploration and production (E&P) companies to counter the precipitous crude decline. G&P assets are notably correlated with contracted E&P well volumes on their systems, and the selloff in crude resulted in counterparty risk resurfacing. Through the quarter, it traded off with the broader E&P space as investor uncertainty hurt sentiment on the name and caused multiple compression on perceived G&P asset value.
- **Hess Midstream (HESM):** Hess Midstream traded off alongside crude as investors became concerned regarding parent Hess Corp's future development plans and counterparty creditworthiness. Notably, Hess Corp cut its planned Bakken drilling program to 1 rig from 6 starting in May. Hess Midstream's assets primarily encompass the G&P system on Hess Corp's Bakken acreage, and the rig drop raised concern regarding the longer term outlook for Hess Corp's activity there.
- **Magnolia Oil & Gas (TPGE):** Magnolia traded down during the quarter as a result of the large downside move in crude oil, accentuated by the company's philosophy of not hedging. While the company has the lowest leverage in the high-yield E&P, the company has a policy of not hedging its forward production given the low leverage. As such, the forward earnings outlook was drastically reduced as a result of the crude selloff. Further, the company's capex philosophy is to only spend at most 60% of annual EBITDAX on its development program. As such, Magnolia will likely underspend maintenance in 2020 and see production decline and increasing leverage, but retain positive free cash flow.

The performance of the Broad High Yield Composite is hypothetical, as the assets of the Select High Yield strategy and the Quality High Yield strategy have been combined to create the Broad High Yield strategy

Positioning

From a sector standpoint, led by our bottom up relative value analysis, the Broad strategy increased its exposure to Basic Industry and Healthcare and retained overweight exposure to Leisure and Telecommunications.

The Broad strategy is underweight the Financials, Transportation and Media sectors and is broadly market weight in the Energy sector, where there is a focus on higher quality issuers within the E&P subsector. We reduced the strategy's exposure to the Automotive sector, from overweight to underweight.

Underweight exposure to CCCs and BBs were maintained, with a corresponding overweight to Bs. In fact, exposure to Bs was increased slightly during the quarter.

As at quarter end, the Broad strategy had a modest allocation to bank loans. In Q120, we found some loans that offered value relative to the High Yield market due to their dislocation mentioned earlier, and took advantage of that to add exposure.

Breakdown by Rating

	Broad	Index
BB	44.47%	50.18%
B	46.27%	34.31%
CCC	3.78%	9.59%

Sector Weightings

Security Description	Broad	Index
Automotive	1.5%	1.9%
Basic Industry	13.4%	10.2%
Capital Goods	6.1%	6.7%
Consumer Goods	5.9%	5.6%
Energy	9.5%	8.9%
Financial	2.6%	7.4%
Healthcare	11.7%	10.9%
Leisure	7.7%	4.6%
Media	8.0%	10.8%
Real Estate	1.0%	1.8%
Retail	4.8%	4.7%
Services	6.6%	6.2%
Technology & Electronics	5.3%	5.5%
Telecommunications	12.5%	10.6%
Transportation	0.0%	1.0%
Utility	1.3%	2.7%

Outlook

Uncertain and volatile market conditions in the March quarter reaffirmed our conviction that effective investing in the High Yield market is first and foremost about risk control. The current market highlights - painfully - that High Yield investing is often more about what you don't own, rather than what you do. The importance of risk control is particularly relevant in leveraged credit, as the asymmetric return profile is pronounced. Issuers can trade down in a vacuum as forced selling pressure creates havoc.

Prior to the Q120 market break, we believe our composite portfolios were significantly underweight credit default risk, relative to the broad market. We felt well positioned to take advantage of the market correction by calmly rotating into credits that fit our process, and added significant yield, and total return upside to our portfolios.

First State Investments became relatively active in our High Yield portfolios during the second half of 2019. This led us to actively rotate portfolios into a slightly more defensive posture, while not sacrificing on price. In turn, portfolios were in a position of relative strength as the market disruption intensified in the March quarter. While market liquidity was challenging overall during the period, given our flexibility and current position we were generally able to supply the market with liquidity in extreme down days, as well as sell names we wanted to in strong up days.

As the current COVID-19 pandemic and financial stress continue to hang over the markets, we expect the US High Yield sector to experience further bouts of indiscriminate selling. This should present opportunities for disciplined investors in due course. While recent market moves have been dramatic, we intend to systematically apply our rigorous, time-tested investment process, gradually taking what the market offers and rotating into 'good' credit at the right price. We remain steadfast to the view that High Yield is primarily about risk control and remain committed to our disciplined and dynamic, fundamental investment process. While challenging, we view the current market as an attractive entry point into High Yield given our view on current market dynamics (summary below).

FUNDAMENTALS

- Credit fundamentals have been weakening as the impact from the COVID-19 pandemic has caused a sharp slowdown in the economy.
- More pronounced pockets of weakness are found primarily in Energy and other industries, like Airlines, shutting down capacity as social distancing and shelter in place policies are instituted.

CREDIT SPECIFIC

TECHNICALS

- High Yield funds saw outflows of \$16.7 billion in the first quarter. Loans Funds reported quarterly outflows of \$11.6 billion during the same period: forced selling resulted.
- Work from home policies caused some disruption with the Broker Dealer community during the quarter, though extreme volatility calmed in the last week of March.

CONTINGENT

VALUATIONS

- The high yield OAS of +875 bps continues to more than appropriately compensate investors for anticipated credit losses in the market.
- The global issuer default rate finished the quarter at 3.54%.
- We do not anticipate a widespread breakdown in fundamentals and believe current high coupons will provide strong tailwind to investors over time.

SUPPORTIVE

Co-Portfolio Managers: High Yield



Jason Epstein
Senior Portfolio Manager
Co-Head of High Yield

Jason joined First State Investments in September 2016. He has 18 years of industry experience.

He was a Managing Director with Oak Hill Advisors where he was responsible for managing a team of analysts covering a broad range of sectors.

Prior to Oak Hill, Jason was an analyst within investment banking at Credit Suisse First Boston where he was a member of both the Financial Sponsors and Technology groups.

Jason has a BS in Economics from The Wharton School, University of Pennsylvania.



Matt Philo, CFA
Senior Portfolio Manager,
Co-Head of High Yield

Matt joined First State Investments in May 2016. He has 30 years of industry experience.

He was Executive Managing Director & Head of High Yield at MacKay Shields LLC.

He managed the Mainstay High Yield Corporate Bond Fund (MYHIX) from December 2000 through May 2014.

Matt has an MBA in finance from New York University and a BA from University at Albany SUNY. Matt is a CFA Charterholder.

For further institutional enquiries contact institutionalenquiries@firststate.co.uk

Important Information

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