Jon Salstrom [00:00:02] Hello, everyone. My name is Jon Salstrom. I'm an Investment Director on our Fixed Income team. I want to thank you for listening to our podcast today. I'm joined by the Co-Heads and Co- Portfolio Managers of our High-Yield platform, Matt Philo and Jason Epstein.

Matt Philo [00:00:15] Pleasure to be here, Jon.

Jason Epstein [00:00:16] Hi, Jon. Thanks for hosting.

Jon Salstrom [00:00:17] Our aim today is to share some general observations and thoughts and some insights as investors all over the world are trying to come to grips an understanding of what the impact of the Coronavirus pandemic will have on the global economy. On top of these general views, we want to dive into some specific areas. Number one, how has the crisis impacted the U.S. leveraged credit market? Number two, which industries will or have been the worst impacted, such as energy, gaming? And then finally, with yields at 10 percent and spreads north of 850. What are the opportunities that we're seeing in the market right now, as well as some of the risks? How have we adjusted our portfolios? Why don't we begin with the broad view on market, Matt?

Matt Philo [00:00:56] Thanks, Jon. The one thing in common is any significant market break. We always see net opportunity to do our contrarian rotation into credits that fit our process, but offer greater yields and greater total return potential. So we're always a little excited when we get this kind of market break. If you think about past cycles, the 98 through 2002 was an extended multi-year ordeal and spreads got just north of 10 percent over a comparable treasury bond or over 1000 basis points to use a different lingo. And then the Great Financial Crisis spreads got to 20 percent or 2000 basis points, which was a record by far, but really only lasted one quarter, followed by a record year on the upside. Then we had a couple of mini corrections in 2011 and 2016 where spreads got out towards 9 percent or 900 basis points. And then the current correction in March at the lows we were at ten point eight percent or 1080 basis points above comparable treasuries. And now with a rally that is not definitively, you know, we can still go down and we could there could still be price volatility. But right now we're around 9 percent or nine hundred basis points, which by definition to us, if we implement our prices correctly, is going to offer a great opportunity to rotate our portfolio and has into higher yielding, higher total return potential credits. So it's never easy to go through something like this, but we are never afraid of it and always view it as offering net opportunity, even if you're invested going into it. So we're having fun.

Jon Salstrom [00:02:42] Jason and you know, a similar topic. You know, given the lessons learned from this past economic downturns, from your experience, you know, do those lessons apply in this current market dynamic that we're facing?

Jason Epstein [00:02:53] Thanks, John. While the cause of this crisis is certainly unique, the current market weakness that has resulted in significant credit spread widening and the associated government intervention response is similar to past cycles. We can apply the lessons we've learned during them to their current investment dynamic. First off, it's always important to get the credit work right. Market drops like we've seen recently and in past cycles, have the effect of differentiating between winners and losers, and that is why sound investment process is so important as well. We've learned that liquidity is paramount. The global financial crisis hit the high yield market with a sharp fall off in the second half of 2008, followed quickly by a strong recovery throughout 2009. As Matt was talking about, the lesson there of having liquidity in order to capitalize on down days and for sellers in the market remains. While we do not know when the economy will spring back to life in the current situation, we do know that it will at some point and along the way we want to be in a position to be providers of liquidity. We've already seen some of this occurring and in late March and early April and the folks who recognize the right names and can be buyers, at weakness will be the long term winners in today's market.

Jon Salstrom [00:04:05] Perfect. Matt, why don't we pivot back to you and talk a little bit more about the specifics of the U.S. leveraged credit markets and what the current economic malaise has on some of the fundamentals, technicals and valuations.

Matt Philo [00:04:18] Sure. Church starting with valuation. Quite amazing that in February of this year in terms of price, the high yield index is represented by the ICE BMO, U.S. high yield constrained index, which you'll see in any of our product literature. The Spread-to-Worst to the yield premium to comparable U.S. Treasury bond was 3.7 percent or 370 basis points and the average bond price was 101 above par. And then by March 23rd, over just a four week period, prices collapsed in the high yield market. Twenty two percent. And that was a function of certainly the COVID-19 unprecedented quarantine slash effective shut down the economy. And this problem is more global than I've ever seen. It's not like the Great Financial Crisis wasn't global. But this, this is truly global. It's larger. Debt levels are larger, both public and private. And the global quarantine, frankly, is unchartered territory. Nobody knows what effect it's going to have on the economy. So fortunately, our process, if we listen to it and effectively implement it, steers us through pretty much anything. I'd say that besides fitting the process, liquidity is a premium factor now and credits because the worst case certainly includes an extended recession or and a pretty unprecedented decline into that recession based on the shutdown and then other effects are typical to any correction? Trading liquidity at pretty thin. We are always better like we own in high yield. The new issue market shut down is now tentatively open in which the well-known issuers know a lot of them secured and so might some IG credit, investment grade credits fell into our market. That'll be a trend that continues. But Occidental Petroleum, Western Midstream Partners, Macy's in retail. So it's an exercise that we're used to; a market break, the contrarian rotation. However, this is uncharted territory in terms of the global effective shut down the economy. There may not be a historical precedent in the history of mankind.

Jon Salstrom [00:06:31] Jason, with those comments from Matt. What specific industries and high yield do you think are most susceptible or vulnerable? Given everything that's going on in the market?

Jason Epstein [00:06:41] Yeah, the weakest sectors of high yield this year have been energy on the back of the steep decline in oil prices and the leisure, gaming, aerospace industries due to the massive effects that the quarantine's have had on their operations and their financial pictures. Energy is one of the largest sectors in high yield and it will likely see significant defaults over the near term. Interestingly, even through the turmoil that lower oil prices have had on the industry, the industry is poised to sniffly grow its weight in the index due to the massive investment grade downgrades that Matt talked about briefly, some of them have already happened and they're going to continue to happen. Bigger picture of the high yield market is 1.2 trillion dollars roughly in size in them. And they may they may see fallen angels of 200 billion plus or more in 2020. Our strategy in energy has been and will continue to be to own the right credits. Names that can handle a prolonged period of weakness in oil prices as well. Leisure is a sector where we have taken advantage of a steep decline in bond and low prices in order to selectively add exposure to names that we believe have excellent business models and have the cash flow to handle current conditions and thrive on the other side of this. In sectors such as gaming and aerospace and a little bit of retail, we've so far taken in a very conservative approach in tackling risk.

Jon Salstrom [00:08:07] Now, Matt you've mentioned a few of the economic crises that we've faced before, you know, looking at the U.S. high yield market. Do you think we're in a better or worse position overall leading into this current economic downturn?

Matt Philo [00:08:21] In terms of credit quality we wrote on this in November 2019. If you look at our website under insights the Q3 high yield quarterly update, the one called analysis covers this topic. And we think it is a pretty big deal in terms of the credit quality of high yield. We have no doubt that the average credit quality of the high yield market's meaningfully stronger than historic credit norms staring sustained upcycle that approaches full valuation.

And then you 'well why's that?' and for much of this bull market credit and high yield, the leveraged loan market was growing very, very fast with the CLO machine cooking. But the leveraged loan market grew by 70-75 percent in just the three years since the end of 2013 and surpassed the size of the high yield market after you know in my career is normally been about half the size, the high yield market. Now it's a bigger. And so why were it why were issuers favoring the loan market? It was because of CLO demand and the prevalence of a lot of loan only financings. People highlight that as a risk and leverage loans not that we don't like some loans and covenants were no longer a big problem for issuers and covenant-lite became the norm. And also, private debt markets has been the buzzword during this upcycled higher fee leverage products. They cannibalize some corporate demand for high yield also especially in the financings for LBO's. And that's really big because back in 2008, the pre-credit crisis, LBO's were all going to go bankrupt without the Fed stepping in, or virtually all, they were very, very aggressive and very big. That market's grown faster than any asset class the B of A's ever followed in credit. And it's people guess it's about the size of the high yield market. And of course, much of that, if you look at private debt markets, it offers virtually zero secondary market liquidity. So we like high yield, no leverage, no derivatives. We have indentures the wind's at our back in terms of income and the high yield asset class is the only one that hasn't grown in size over the past six years. It's growing, just growing just lately. But the previous six years and hadn't grown. And that was the only asset class. And that's quite different than normal credit upcycle. So that that's a positive.

Jon Salstrom [00:10:50] Jason coming back to you, kind of with that backdrop of Matt talking about the market and where we are heading into this. You know, generally speaking, how has high yield performed following economic or credit bottoms?

Jason Epstein [00:11:00] Yeah, in general, John, the answer is very well. In fact, after the high yield market as a whole as widened to spreads of 1000 basis points over treasuries, the 1 to 3 year returns have been uniformly positive, 20 percent plus on average and in some cases significantly higher than that. However, that doesn't mean the path will be smooth or easy. In fact, when I was earlier talking about the sharp fall off and the bounce back of high yields during the global financial crisis, and Matt mentioned this as well, if you dig into the data, you'll see that spreads widened to 1000 basis points over in October of 2008, only to widen again and were two thousand over by December of 2008. You know, before the market rallied for a greater 50 percent return in 2009. Simply put. We're not trying to call a bottom of the market or say that it will be smooth sailing from here. However, if we stick to the discipline that we have implanted through our investment process, we will be in the right credits and we were able to handle any market environment. That will leave us in a good position to generate significant total return for our clients when the market recovers.

Jon Salstrom [00:12:05] You know, Matt, coming back to you on the next question here. Given everything we've talked about, how have you adjusted the portfolios that you manage through this market volatility?

Matt Philo [00:12:14] Jason covered much of this in his earlier comments. He's made a lot of good points. But as he highlighted, consumer cyclicals, Energy, Airlines, REITs, these were areas that showed particular weakness for obvious reasons. When people are quarantined, they're not going to be doing a lot of gaming or lodging or or shopping. And in energy, it was the price of oil going to extreme, extreme lows relative to where it's been the last few years. I think it may have broken $20 a barrel WTI very, very briefly. Now it's back up some. So those areas have been weak and I can't say every subsector of consumer cyclicals we've found value. But in a few of them we have and in E&P we're always active. And then basic industry as well. It may not be a leader on the downside, but the selling from crossover investors has been kind of pleasant. Meaning we think some crossover credits, especially basic industry, have sold off a lot more than they should have. And we stay high in the capital structure in terms of, you know, we like secured debt, obviously, but we've found some crossover credits in basic industries that have been of interest as well. We have no certainty that the rebound since March 23rd was the absolute low. We have no certainty that

that is the low of this cycle. And the reason is pretty obvious. We have no real visibility on how bad the global economy is going to get. A lot depends on how long the key engines of the global economy remain largely shut down. And that's hard to predict. And so, again, that circles back to we stick with our process, things that fit our process. Our analysis has to include a pretty severe recession. And that means obviously it's always true. But now, more than ever. Liquidity, staying power of a company, especially a cyclical company, is more important than ever. So that's the big picture of what we've been doing. And we've been adding yield and total return to our portfolio. But we haven't fired all our bullets and we have nice mobility. It is it is a big advantage to have mobility and we think that will allow us to handle potential increased volatility going forward better than our competitors.

Jon Salstrom [00:14:58] Well, I want to thank. Well, you guys for your time. We got one more question, Matt, we started with you. Jason, why don't we finish with you? How are you investing in the high yield market today?

Jason Epstein [00:15:08] Yeah, I mean, you know, Matt touched on it just now. We haven't changed our investment process one bit. Our process focuses on having an adequate margin of safety to guard against defaults and allows us to implement a contrarian rotation into riskier credit when we see, you know, the superior relative value. You know, we know that current market conditions aren't easy, but our investment process steers us through, you know, this and any other kind of tough environment. Mobility, as Matt mentioned, is going to help us as well. We have patiently waited for an opportunity like the current market, and we're excited by the opportunity to generate significant total returns for our clients. The beauty of high yield is that the wind is at our backs and in the form of current income and we think our differentiated portfolio is well set up for future.

Matt Philo [00:16:00] I'll make one final comment, if I may. Jason's, spot on with his observations, of course, because we're Co-Heads and Co-PM's, we're kind of attached at the hip, but people, I think, would be surprised how calm the exercise is following our investment process and rotating the portfolio into higher yielding, higher total return credits. It's very methodical. And for quite some time we've been highlighting that the high yield asset class is relatively cheap compared to other risk credit sectors. And now it's fun to be able to say it's absolutely cheap. The absolute total return potential is great. And so that's a lot of fun and good opportunity for investors, we think. Thanks.

Jon Salstrom [00:16:44] Well, in conclusion, I just. Matt, Jason, thank you for your time today. I really think we covered a lot of ground here and appreciate everything you guys had to say.

Jason Epstein [00:16:52] My pleasure, Jon.

Matt Philo [00:16:53] Thank you. Yeah. Thanks for your time, Jon.