

High Yield Market Update

High yield market returns benefited from income generation, lower rates and spread tightening supported by earnings beats and a steady view around an economic recovery as pandemic restrictions were relaxed and the percentage of the population vaccinated increased. Energy was the top returning sector for the quarter as oil prices moved higher. WTI Crude closed the period up \$14.31/bbl (or 24.19%) to \$73.47/bbl. In the later part of the quarter, treasury markets were a focus for investors as a new dot plot stemming from the June FOMC meeting led to rate volatility and curve flattening helping longer-duration assets to outperform. Treasuries ended the period with the 2-year up 9 basis points (bps) to 0.25% and the 10-year lower by 27 bp to 1.47% and the US Dollar Index was down 0.85%.

Technicals were a headwind in the second quarter of 2021 as outflows were met with a continuation of strong new issuance. High yield funds and ETFs had outflows of \$4.1bn while loan funds saw inflows of \$14.0bn, as tracked by Lipper and reported by Barclays. Q2 bond new issuance was slightly down, with \$134.7bn pricing in the quarter, offset by \$78.9bn of bond redemptions, leaving net supply at \$55.8bn for the period, per Barclays.

The percentage of the market trading at distressed levels (below 70% of par) ended the quarter at 0.9%; the comparable figure for the loan market (below 80% of par) was 1.6%, per JP Morgan. The par-weighted twelve-month high yield bond default rate decreased to 2.5% by quarter-end, per BofA Merrill Lynch.

The ICE BofA US High Yield Index returned 2.77% in Q2, ending the period with an average price of 105.29, a 1.21-point increase from the prior quarter. Credit spreads tightened by 30 bps to 299 bps and the yield-to-worst (YTW) declined by 0.39% to 3.77%. High yield underperformed small cap equities, represented by the Russell 2000's 4.05% return, as well as large cap equities, as represented by the S&P 500's 8.17% return, and investment grade corporates, as represented by the ICE BofA US Corporate Index's 3.60% quarterly return. In high yield, the Double-B, Single-B and Triple-C sub-indices returned 2.90%, 2.11% and 4.10%, respectively. Returns were positive across all sectors for the quarter: the top performer was Energy, which saw a 6.09% return, while Healthcare was the bottom-performing sector with a 1.42% return.

Portfolio Performance

Portfolios managed according to our **Unconstrained Broad High Yield Market Strategy** (BHYM) posted strong absolute returns in Q2, performing in line with the index. By risk segment (defined by yield and duration to worst), security selection was a source of outperformance while allocation was a source of underperformance. Strong selection within the shortest duration part of the market was a positive contributor to relative performance but was offset by underweights to the highest performing, most speculative part of the market (yielding 9%+) and the longest duration (over 9.0) part of the market. By sector, strong selection in Capital Goods and Media were positive contributors to relative performance but were offset by an underweight to top-performing Energy. By rating, strong selection in Single-B and Double-B rated securities helped relative returns while weaker selection in Triple-Cs and an overweight to Single-Bs hurt relative returns.

SKY Harbor's Unconstrained **Short Duration High Yield Strategy** (SDHY) portfolios posted solid returns in Q2, capturing approximately 60% of the US high yield market return (as measured by the ICE BofA US High Yield Index) on a gross-of-fee basis which is in line with the historical capture rate for the strategy. By risk type, generally longer duration (within the context of short duration) outperformed the shortest duration, most defensive securities. By sector, Transportation and Media led again while Utility and Telecom lagged though all sectors were positive in Q2. By rating, the lowest part of the market continued to show some of the strongest returns as has been the case with the overall high yield market. Looking forward, we continue to focus on maintaining a relatively high current income through valuation discipline and the reinvestment of cash flows into positions that offer incremental income and alignment with the key themes associated with our FASST process.

Portfolio Characteristics

Representative Broad High Yield Market Portfolio

Characteristics	Portfolio ¹	HY Market	Distribution by Sector	Portfolio ¹	HY Market	SKY as % of HY Market	
Avg Years to Maturity	6.1	6.5	Basic Industry	16.1%	8.0%	201%	
Yield to Worst	5.03%	3.77%	Capital Goods	15.8%	6.4%	249%	
Current Yield	6.65%	5.55%	Media	14.1%	8.9%	157%	
Duration to Worst	2.8	3.5	Services	8.0%	5.5%	147%	
OAS	427	299	Technology & Electronics	8.0%	4.8%	168%	
Avg Coupon	6.99%	5.84%	Automotive	5.4%	5.0%	110%	
Number of Issuers	92	921	Healthcare	4.9%	8.8%	55%	
Number of Issues	112	2100	Real Estate	4.6%	4.2%	108%	
Average ML Rating	B3	B1	Energy	4.2%	13.5%	31%	
Average Price	105.1	105.3	Retail	4.1%	4.9%	84%	
			Financial Services	4.1%	4.3%	94%	
			Leisure	3.6%	6.5%	56%	
			Transportation	2.6%	2.0%	129%	
			Consumer Goods	2.5%	5.0%	50%	
			Telecommunications	1.9%	6.7%	29%	
			Utility	0.0%	3.0%	0%	
			Insurance	0.0%	1.1%	0%	
			Banking	0.0%	1.3%	0%	
Distribution by Rating	Portfolio ¹	HY Market					
A Holdings	0.0%	0.0%					
BBB Holdings	0.0%	0.0%					
BB Holdings	13.2%	54.6%					
B Holdings	59.7%	33.5%					
CCC or Under	27.1%	11.9%					
Distribution by Issue Size	Portfolio ¹	HY Market					
0 - 250M	5.0%	0.6%					
250 - 500M	41.1%	23.8%					
500 - 750M	23.1%	21.9%					
750 - 1000M	17.7%	17.7%					
1000+M	13.1%	35.9%					
Top 5 Holdings by Weight	BofA Rating	Issue Size (\$mil)	Current Price	BofA Industry	Duration to Worst	Yield to Worst (%)	% of Portfolio
New Home Company Inc 7.250% 15-Oct-2025	B3	285.0	105.97	Basic Industry	1.21	5.15	2.36
QUAD/GRAPHICS 7.000% 01-May-2022	CCC1	238.7	99.00	Media	0.79	8.22	2.34
Townsquare Media Inc. 6.875% 01-Feb-2026	B2	550.0	107.00	Media	1.47	2.34	1.98
Avaya Inc. 6.125% 15-Sep-2028	B1	1,000.0	107.03	Technology & Electronics	2.03	4.10	1.87
Unisys Corporation 6.875% 01-Nov-2027	B1	485.0	109.28	Technology & Electronics	2.14	4.08	1.86

Representative Short Duration High Yield Portfolio

Characteristics	Portfolio ¹	HY Market ²	SD Universe ³	Distribution by Sector	Portfolio ¹	HY Market ²	SD Universe ³
Avg Years to Maturity	4.3	6.5	3.5	Basic Industry	12.5%	8.0%	8.4%
Yield to Worst	3.46%	3.77%	2.84%	Capital Goods	11.8%	6.4%	7.1%
Current Yield	6.50%	5.55%	5.77%	Media	11.5%	8.9%	5.4%
Duration to Worst	1.4	3.5	1.8	Technology & Electronics	9.3%	4.8%	4.9%
OAS	319	299	250	Services	9.1%	5.5%	4.7%
Avg Coupon	6.88%	5.84%	6.12%	Automotive	6.7%	5.0%	4.0%
Number of Issuers	148	921	451	Healthcare	6.5%	8.8%	7.4%
Number of Issues	197	2100	689	Telecommunications	5.7%	6.7%	5.5%
Average Rating	B2	B1	BB3	Financial Services	5.4%	4.3%	6.9%
Average Price	105.79	105.29	106.04	Transportation	5.3%	2.0%	4.2%
				Real Estate	4.7%	4.2%	4.8%
				Leisure	4.5%	6.5%	8.6%
				Retail	4.2%	4.9%	5.3%
				Consumer Goods	2.3%	5.0%	3.0%
				Other	0.5%	0.0%	0.0%
				Utility	0.0%	3.0%	2.4%
				Insurance	0.0%	1.1%	0.7%
				Banking	0.0%	1.3%	2.1%
				Energy	0.0%	13.5%	14.6%
Distribution by Rating	Portfolio ¹	HY Market ²	SD Universe ³				
A Holdings	0.0%	0.0%	0.0%				
BBB Holdings	1.9%	0.0%	0.0%				
BB Holdings	22.6%	54.6%	57.0%				
B Holdings	58.9%	33.5%	43.0%				
CCC or Under	16.5%	11.9%	0.0%				
Distribution by Issue Size	Portfolio ¹	HY Market ²	SD Universe ³				
0 - 250M	5.7%	0.6%	0.1%				
250 - 500M	31.0%	23.7%	17.6%				
500 - 750M	23.0%	21.8%	25.7%				
750 - 1000M	13.5%	17.7%	15.1%				
1000+M	26.8%	36.1%	41.5%				
Top 5 Holdings by Weight	Average Rating	Issue Size (\$mil)	Current Price	BofA Industry	Duration to Worst	Yield to Worst (%)	% of Portfolio
Meredith Corp 6.875% 01-Feb-2026	CCC1	1,022.5	104.00	Media	0.08	0.12	2.13
American Airlines Inc. 11.750% 15-Jul-2025	B1	2,500.0	125.50	Transportation	3.20	4.74	1.72
Delta Air Lines Inc 7.000% 01-May-2025	BBB3	3,500.0	116.74	Transportation	3.39	2.40	1.44
Banff Merger Sub Inc 9.750% 01-Sep-2026	CCC2	1,475.0	105.25	Technology & Electronics	0.16	6.91	1.15
Sabre Global Inc. 7.375% 01-Sep-2025	B1	850.0	108.75	Services	1.10	2.82	1.15

¹ Exclusive of Cash. ^{2,3} The Short Duration High Yield strategy is not a benchmarked product; the HY Indices shown are provided solely as a relative market indicators. This comparison of selected characteristics of representative SKY Harbor portfolios on or about June 30, 2021 is provided for illustrative purposes only and is subject to change without notice in accordance with the strategies' stated objectives and the sole discretion of SKY Harbor's portfolio management team. Source: SKY Harbor, FactSet, ICE BofA US High Yield Index "HOAO" (HY Market) and ICE BofA 1-5 Year BB-B US Cash Pay High Yield Constrained Index "JCV4" (SD Universe).

Outlook

Investors in risk assets have moved from concern regarding COVID-19 and the global vaccine roll-out to a focus on rising inflationary pressures and the timing and path to higher rates. Valuations across risk assets are also top of mind for credit investors and concern regarding the spread of virus variants across unvaccinated populations.

Investor perception of risks around fundamentals has benefited from a strong recovery in earnings and generally strong aggregate economic data that is supportive of tighter credit spreads over time. Default risk is rapidly normalizing, and the credit ratings cycle is swinging to the positive after a pandemic-induced downgrade cycle. We continue to believe that there remains an opportunity around spread compression based upon

lower defaults and strong economic and market conditions.

We believe the market has excess return opportunity associated with carry, sector allocation and credit picking and are mindful of tighter valuations across better quality segments of the market. Unlike last year where picking bonds with recovering results and attractive valuations was a key driver of returns, this year we expect returns will be a function of missing companies that stumble and are related to higher yields. Our valuation work suggests a modest bias towards cyclicals versus defensive issuers and a continued bias towards smaller issue sizes over larger issues. We are also biased towards the sectors that are better positioned for somewhat higher corporate taxes and rising raw material costs and labor-related headwinds.

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