# SKY HARBOR CAPITAL MANAGEMENT

Q3 '19 Commentary

## High Yield Market Update

Better-than-expected Q2 earnings combined with Federal Reserve late-cycle rate cuts propelled the high yield market to a third positive quarterly return this year, despite ongoing geopolitical uncertainty. Volatility continued as the US and China further jostled for negotiating position in the ongoing trade war, but negative global interest rates and relatively steady US economic data supported credit demand. As predicted by the market, the Federal Reserve cut interest rates in both July and September and, importantly, remains on a "do what is necessary" path to sustain economic growth. Adding layers of risk, the Energy sector was volatile throughout the quarter, with oil spiking in price post an attack on Saudi Arabia's energy production in September, only to fall back on fears of slowing global growth, causing WTI Crude to be down $4.40 (or -7.53%) to $54.07/bbl for Q3. The US Dollar Index declined 1.19% and Treasuries ended the quarter with the 2-year down 9 basis points (bps) to 1.67% and the 10-year lower by 32 bps to 1.68% as the yield curve flattened.

Technicals were mixed in the quarter as high yield funds and ETFs had inflows of $3.3bn while loan funds saw continued outflows of $9.1bn, as tracked by Lipper and reported by Barclays. Net supply was positive for Q3 as bond new issuance was steady, pricing $64.9bn in the quarter, offset by $54.7bn of bond redemptions, leaving net supply at $10.2bn for the period, per Barclays.

The percentage of the market trading at distressed levels (below 70% of par) ended the third quarter at 5.2%; the comparable figure for the loan market (below 80% of par) was 4.9%, per JP Morgan. The par-weighted twelve-month high yield bond default rate increased to 1.67% at quarter-end, per BofA Merrill Lynch. Excluding commodities, the default rate was 0.61%.

The ICE BofAML US High Yield Index returned 1.22% in Q3, ending the period with an average price of 99.09, a 0.21-point increase from the prior quarter. Credit spreads tightened by 8 bps to 398 bps and the yield-to-worst (YTW) was lower by 0.23% to 5.82%. High yield outperformed small cap equities, represented by the Russell 2000's -2.41% return, but underperformed investment grade corporates, as represented by the ICE BofAML US Corporate Index's 3.07% quarterly return, as well as large cap equities, as represented by the S&P 500's 1.70% return. In high yield, the Double-B, Single-B and Triple-C sub-indices returned 2.06%, 1.22% and -2.27%, respectively. Most sectors generated positive returns for the quarter: the top performer was Insurance, which saw a 5.14% return, while Energy was the bottom-performing sector, posting a -4.56% return, the only negative sector for the quarter.

## Portfolio Performance

Portfolios managed according to our Unconstrained **Broad High Yield Market Strategy** BHYM) posted solid returns in Q3, outperforming the benchmark. By risk type, both security selection and allocation were sources of outperformance. The primary drivers of relative returns were strong selection within the bottom-performing most speculative part of the market as well as a significant underweight to this segment. Positive relative performance was somewhat reduced by weaker selection within the intermediate part of the market (yielding 7-8%) and an underweight to the higher-performing, better quality, most rate sensitive part of the market. By sector, a significant underweight to bottom-performing Energy and strong selection in Retail were positive contributors to relative performance partially offset by weaker selection in Services and an underweight to higher-performing Telecom.

On a representative basis, the top contributor to BHYM returns was Weight Watchers International (WW) 8.625% notes of 2025, which traded up during the quarter on solid Q2 earnings, stabilization of recruitment and a significant shareholder/strategic partner's announcement of a national tour. Last quarter's top contributor, Townsquare Media (TSQ) 6.5% notes due 2023, was among top contributors again, trading up on strong Q2 earnings. The largest bottom contributor to quarterly returns was TMS International (TMS) 7.25% notes due 2025, which traded down in sympathy with steel producers who provided mixed steel demand and pricing outlooks for the end of 2019. Last quarter's bottom contributor, Exela Intermediate 10% notes due 2023, was liquidated during Q3.

### Broad High Yield Market Strategy: Performance

| | SKY Harbor BHYM Strategy Performance | | | |
|---|---|---|---|---|
| | Gross of Fees | Net of Fees | ICE BofAML US HY Index | Alpha[1] |
| July 2019 | 0.63 | 0.60 | 0.51 | 0.12 |
| August 2019 | 0.79 | 0.76 | 0.39 | 0.40 |
| September 2019 | 0.61 | 0.58 | 0.32 | 0.29 |
| Q3 2019 | 2.04 | 1.96 | 1.22 | 0.82 |
| Year to Date 2019 | 11.32 | 11.06 | 11.50 | -0.19 |
| Last 12 Months | 6.49 | 6.17 | 6.30 | 0.19 |
| Three Years (annl) | 6.38 | 6.06 | 6.07 | 0.31 |
| SI Return (annl) | 7.47 | 7.14 | 7.42 | 0.05 |

1 Based on gross of fees. Fees disclosed in SKY Harbor Form ADV, Part 2.
SI=Since Inception. Broad High Yield Market Composite inception date: 9/30/11.
Data displayed may not sum due to rounding.

SKY Harbor's Unconstrained **Short Duration High Yield Strategy** (SDHY) portfolios posted solid positive returns during 2019's third quarter, outperforming the broader US high yield market return (as measured by the ICE BofAML US High Yield Index), on a gross basis, with significantly less volatility. Generally, intermediate duration (within the context of short duration) outperformed shorter duration securities and more speculative securities in Q3. By sector, Retail and Insurance were the top performers for the quarter, while Energy lagged, posting the only negative return. By rating, lower quality led, with Triple-Cs outperforming Single-Bs and Double-Bs.

On a representative basis, at quarter-end our SDHY portfolios had a YTW of 3.87% (67% of the broad market yield). Exclusive of cash, the average coupon was 6.15% vs. the market average of 6.37% and the duration-to-worst was 1.3 (or 41% of the broad market). Holdings (326 issues, representing 218 issuers) comprised 43% bonds with maturities of less than three years and 57% in longer maturities that are trading to expected early take-outs inside this three-year period. This overweight to the latter group continues to show that we find greater value in the yield-to-call opportunities. Nevertheless, we do value the relative price stability the short maturity group can offer in volatile periods.

**Short Duration High Yield Strategy: Performance**

| | SKY Harbor SDHY Strategy Performance | | | | Annualized Daily Volatility[2] | | |
|---|---|---|---|---|---|---|---|
| | Gross of Fees | High Yield Market[1] | Market Capture[2] | Net of Fees | SKY SDHY Strategy | High Yield Market[1] | Relative Volatility |
| July 2019 | 0.48 | 0.51 | 93% | 0.45 | 0.7 | 1.6 | 42% |
| August 2019 | 0.45 | 0.39 | 114% | 0.42 | 2.0 | 4.1 | 48% |
| September 2019 | 0.32 | 0.32 | 101% | 0.29 | 0.6 | 1.8 | 32% |
| Q3 2019 | 1.25 | 1.22 | 102% | 1.17 | 1.2 | 2.7 | 45% |
| Year to Date 2019 | 7.62 | 11.50 | 66% | 7.36 | 1.5 | 3.1 | 50% |
| Last 12 Months | 5.16 | 6.30 | 82% | 4.82 | 1.9 | 3.5 | 53% |
| Three Years (annl) | 4.92 | 6.07 | 81% | 4.57 | 1.5 | 2.8 | 53% |
| Since Inception (annl) | 4.62 | 6.72* | 69% | 4.2 | 1.8 | 3.5 | 54% |

1. The Short Duration High Yield strategy is not a benchmarked strategy. The HY Market index shown (ICE BofAML US HY Index) is provided solely as a relative market indicator. * Correction
2. Based on gross of fees. Fees disclosed in SKY Harbor Form ADV, Part 2.
Short Duration High Yield Composite Inception date: 10/31/11

## Outlook

While trade discussions, geopolitical risks and China are likely to continue to impact risk premiums, overall high yield fundamentals and technicals remain generally supportive, in our view. We see growing concern around second half of the year earnings and some increased concerns around the timing of the next cyclical downturn. With the market's recent adjustment to lower Treasury rates and somewhat weakening US manufacturing and other indicators of economic activity, we view high yield spreads as fairly valued and expect credit selection to drive returns on a go-forward basis. Overall, we continue to believe the high yield market can provide attractive full-year returns with some elevated volatility.

Our Broad High Yield Market (BHYM) portfolios are modestly underweight the better-quality, lower-yielding segment of the market in favor of credit picking among the higher-yielding part of the market and an overweight to the defensive short duration parts of the market. We continue to focus on those industry groups that are best positioned for sustainable growth in an aging economic cycle. We had substantially reduced our exposure to US housing, the Energy sector and industries that have a high degree of sensitivity to Chinese growth although we added back some housing-related risk as lower rates improved near-term affordability in a number of markets. Our BHYM portfolios remain more concentrated in high conviction holdings than has been the case in recent years and are benefiting from outperformance by this part of the portfolio generally. Based on our view of risks and valuations across the market, we continue to believe Single-B rated credit offers the best opportunity for attractive returns through credit picking.

Turning to the SDHY strategy, we believe our portfolios remain well positioned for the current market environment as they are capturing nearly 70% of the market yield with about 40% of the market duration. In our view, the high current income combined with the typically defensive nature of the portfolio results in an attractive asset class better insulated from potential market volatility, pending resolution of geopolitical events. We expect that continued high natural turnover, created by calls, tender and maturities, will allow us to optimize the portfolio as the environment evolves and volatility creates opportunities in the market.

# Portfolio Characteristics

## Representative Broad High Yield Market Portfolio

| Characteristics | Portfolio[1] | HY Market |
|---|---|---|
| Avg Years to Maturity | 5.6 | 5.7 |
| Yield to Worst | 5.63% | 5.82% |
| Current Yield | 6.75% | 6.43% |
| Duration to Worst | 2.8 | 3.1 |
| OAS | 372 | 398 |
| Avg Coupon | 6.91% | 6.37% |
| Number of Issuers | 151 | 847 |
| Number of Issues | 172 | 1786 |
| Average ML Rating | B2 | B1 |
| Average Price | 102.4 | 99.1 |

| Distribution by ML Rating | Portfolio[1] | HY Market |
|---|---|---|
| A Holdings | 0.0% | 0.0% |
| BBB Holdings | 0.0% | 0.0% |
| BB Holdings | 25.5% | 49.5% |
| B Holdings | 53.5% | 39.5% |
| CCC or Under | 21.0% | 11.0% |

| Distribution by Issue Size | Portfolio[1] | HY Market |
|---|---|---|
| 0 - 250M | 9.8% | 1.2% |
| 250 - 500M | 45.4% | 28.9% |
| 500 - 750M | 14.1% | 20.7% |
| 750 - 1000M | 10.8% | 15.6% |
| 1000+M | 20.0% | 33.5% |

| Distribution by Sector | Portfolio[1] | HY Market | SKY as % of HY Market |
|---|---|---|---|
| Basic Industry | 13.5% | 10.6% | 128% |
| Media | 12.8% | 10.2% | 126% |
| Services | 12.4% | 6.1% | 204% |
| Healthcare | 11.0% | 9.9% | 111% |
| Capital Goods | 10.1% | 6.6% | 153% |
| Technology & Electronics | 7.7% | 5.3% | 145% |
| Leisure | 7.3% | 5.0% | 145% |
| Retail | 5.1% | 4.6% | 111% |
| Consumer Goods | 3.4% | 3.2% | 109% |
| Energy | 2.8% | 13.0% | 21% |
| Insurance | 2.6% | 1.1% | 227% |
| Transportation | 2.4% | 0.9% | 258% |
| Financial Services | 2.2% | 4.2% | 52% |
| Real Estate | 2.0% | 1.6% | 130% |
| Telecommunications | 1.9% | 10.8% | 17% |
| Automotive | 1.1% | 2.0% | 56% |
| Utility | 1.0% | 2.5% | 39% |
| Banking | 0.8% | 2.4% | 32% |

| Top 5 Holdings by Weight | BofA ML Rating | Issue Size ($mil) | Current Price | BofA ML Industry | Duration to Worst | Yield to Worst (%) | % of Portfolio |
|---|---|---|---|---|---|---|---|
| Townsquare Media Inc. 6.500% 01-Apr-2023 | B3 | 280.1 | 99.75 | Media | 3.08 | 6.58 | 2.44 |
| Bausch Health Companies 9.250% 01-Apr-2026 | B3 | 1,500.0 | 113.50 | Healthcare | 2.25 | 5.13 | 2.15 |
| Unisys Corporation 10.750% 15-Apr-2022 | B1 | 440.0 | 109.25 | Technology & Electronics | 0.51 | 3.26 | 2.10 |
| QUAD/GRAPHICS 7.000% 01-May-2022 | B2 | 243.5 | 102.00 | Media | 2.28 | 6.14 | 2.07 |
| Great Lakes Dredge & Dock Corp 8% 15-May-2022 | B3 | 325.0 | 106.13 | Transportation | 0.59 | 3.61 | 2.04 |

## Representative Short Duration High Yield Portfolio

| Characteristics | Portfolio[1] | HY Market[2] | SD Universe[3] |
|---|---|---|---|
| Avg Years to Maturity | 3.3 | 5.7 | 3.2 |
| Yield to Worst | 3.87% | 5.82% | 4.76% |
| Current Yield | 5.97% | 6.43% | 5.98% |
| Duration to Worst | 1.3 | 3.1 | 1.8 |
| OAS | 198 | 398 | 297 |
| Avg Coupon | 6.15% | 6.37% | 6.05% |
| Number of Issuers | 218 | 847 | 424 |
| Number of Issues | 326 | 1786 | 665 |
| Average Rating | B1 | B1 | BB3 |
| Average Price | 102.95 | 99.09 | 101.13 |

| Distribution by Rating | Portfolio[1] | HY Market[2] | SD Universe[3] |
|---|---|---|---|
| A Holdings | 0.0% | 0.0% | 0.0% |
| BBB Holdings | 2.3% | 0.0% | 0.0% |
| BB Holdings | 47.5% | 49.5% | 54.1% |
| B Holdings | 43.4% | 39.5% | 45.9% |
| CCC or Under | 6.8% | 11.0% | 0.0% |

| Distribution by Issue Size | Portfolio[1] | HY Market[2] | SD Universe[3] |
|---|---|---|---|
| 0 - 250M | 3.7% | 1.2% | 0.0% |
| 250 - 500M | 31.1% | 28.7% | 24.0% |
| 500 - 750M | 20.9% | 20.6% | 25.9% |
| 750 - 1000M | 14.5% | 15.5% | 12.9% |
| 1000+M | 29.9% | 33.9% | 37.2% |

| Distribution by Sector | Portfolio[1] | HY Market[2] | SD Universe[3] |
|---|---|---|---|
| Media | 12.1% | 10.2% | 10.2% |
| Leisure | 9.6% | 5.0% | 4.1% |
| Telecommunications | 9.9% | 10.8% | 9.2% |
| Healthcare | 8.1% | 9.9% | 8.8% |
| Basic Industry | 9.0% | 10.6% | 11.5% |
| Financial Services | 9.5% | 4.2% | 5.6% |
| Capital Goods | 7.5% | 6.6% | 7.1% |
| Technology & Electronics | 5.7% | 5.3% | 5.5% |
| Services | 5.5% | 6.1% | 4.7% |
| Energy | 4.4% | 13.0% | 14.7% |
| Transportation | 3.4% | 0.9% | 2.3% |
| Consumer Goods | 3.5% | 3.2% | 2.8% |
| Retail | 3.7% | 4.6% | 4.3% |
| Real Estate | 3.1% | 1.6% | 2.3% |
| Automotive | 1.8% | 2.0% | 1.5% |
| Utility | 1.7% | 2.5% | 2.0% |
| Banking | 0.6% | 2.4% | 2.4% |
| Insurance | 0.6% | 1.1% | 0.9% |
| Other | 0.4% | 0.0% | 0.0% |

| Top 5 Holdings by Weight | Average Rating | Issue Size ($mil) | Current Price | BofA ML Industry | Duration to Worst | Yield to Worst (%) | % of Portfolio |
|---|---|---|---|---|---|---|---|
| Reynolds Group Issuer LLC. 5.750% 15-Oct-2020 | B1 | 3,136.8 | 100.13 | Capital Goods | 0.08 | 3.21 | 0.95 |
| Sprint Corporation 7.250% 15-Sep-2021 | B2 | 2,250.0 | 106.75 | Telecommunications | 1.82 | 3.66 | 0.83 |
| Nationstar Mortgage LLC 6.500% 01-Jul-2021 | B2 | 591.6 | 100.13 | Financial Services | 0.08 | 3.44 | 0.82 |
| Hertz Corporation 7.625% 01-Jun-2022 | B1 | 1,250.0 | 104.13 | Services | 0.08 | 3.64 | 0.73 |
| Park Aerospace Holdings Limited 5.250% 15-Aug-2022 | BBB3 | 2,050.0 | 105.38 | Financial Services | 2.65 | 3.27 | 0.71 |

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 September 30, 2019 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 BofAML US High Yield Index "H0A0" (HY Market) and ICE BofAML 1-5 Year BB-B US Cash Pay High Yield Constrained Index "JCV4" (SD Universe).

## Disclaimers and Additional Disclosures

SKY Harbor Capital Management, LLC (“SKY Harbor”) provides this document for informational purposes only. The information herein is intended solely for the person to whom it has been delivered. This document may not be reproduced or transmitted, in whole or in part, by any means, to third parties without the prior written consent of SKY Harbor. Nothing contained in this document is or should be construed as an advertisement, or an offer to enter any contract, investment advisory agreement, a recommendation to buy or sell securities of any kind, a solicitation of clients, or an offer to invest in any particular fund, product, investment vehicle, or derivative. This document contains forward-looking statements that are based on SKY Harbor’s current views and assumptions. Forward-looking statements such as the findings of our analytical research, our outlook for interest rates, Fed policy, the economy, high yield markets and the like, or our intended adjustments to the portfolios within our strategies are subject to inherent risks, biases and uncertainties that are beyond SKY Harbor’s control and may cause actual results to differ materially from the expectations expressed herein.

The information contained herein is subject to change, and SKY Harbor is under no obligation to update any information contained herein. Certain information contained in this document has been obtained from third-party sources and, although believed to be reliable, has not been independently verified, and its accuracy or completeness cannot be guaranteed.

Broad High Yield Market Strategy portfolios may include 6%-12% of USD-denominated below-investment-grade corporate debt securities that are not included in the ICE BofAML US High Yield Index (“Index”). These securities may have variable coupon schedules, scheduled maturity of less than one year, USD-listed issuers domiciled outside the US, issues with less than $250 million in debt outstanding and new-issue securities not yet in the Index due to routine timing lag. The Index reflects no deductions for fees, expenses or taxes.

Investing in securities involves risk of loss and past performance is not necessarily indicative of future results. Fixed income securities, especially high yield debt securities, are subject to loss of income and principal arising from credit risk, which is the risk that the issuer will be unable to make interest and principal payments when due. Material risks in investing in high yield debt securities also include, but are not limited to, opportunity cost (the risk that an issuer’s credit trends deteriorate resulting in a higher level of compensation demanded by the market relative to the initial investment), interest rate risk, liquidity risk, selection risk, and overall market risk. In general, issuers of high yield debt securities have a greater likelihood of defaulting on the payment of interest or principal than issuers of investment grade bonds. There can be no assurance that the investment objectives described herein will be achieved or that substantial losses can be avoided.

Gross performance results herein do not reflect the deduction of investment management fees, which would reduce an investor’s actual return. For example, assume that $1 million is invested in an account with the Firm, and this account achieves a 6% compounded annualized return, gross of fees, for five years. At the end of five years that account would grow to $1,338,226 before the deduction of management fees. Assuming management fees of 0.55% per year are deducted annually from the average annual AUM, the value of the account at the end of five years would be $1,302,846, which is the equivalent of an annual compounded rate of 5.43%. For a ten-year period, the ending dollar values before and after fees would be $1,790,848 and $1,697,408, respectively. These calculations do not include custodial fees or transaction costs. SKY Harbor’s asset-based fees are generally billed monthly or quarterly in arrears. Please refer to SKY Harbor’s ADV Part 2A or applicable Offering Documents for more information on fees. Consultants supplied with gross results are to use this data in accordance with SEC, CFTC, NFA or the applicable jurisdiction’s guidelines.

The ICE BofAML Index data referenced herein is the property of ICE Data Indices, LLC (“ICE BofAML”) and/or its licensors and has been licensed for use by SKY Harbor. ICE BofAML PERMITS USE OF THE ICE BofAML INDICES AND RELATED DATA ON AN "AS IS" BASIS, MAKES NO WARRANTIES REGARDING SAME, DOES NOT GUARANTEE THE SUITABILITY, QUALITY, ACCURACY, TIMELINESS, AND/OR COMPLETENESS OF THE ICE BofAML INDICES OR ANY DATA INCLUDED IN, RELATED TO, OR DERIVED THEREFROM, ASSUMES NO LIABILITY IN CONNECTION WITH THE USE OF THE FOREGOING, AND DOES NOT SPONSOR, ENDORSE, OR RECOMMEND SKY Harbor or ANY OF ITS PRODUCTS OR SERVICES.SKY Harbor is not a tax or legal advisor. Prospective investors should consult their tax or legal advisors before making tax-related investment decisions.



For more information, contact SKY Harbor Capital Management, LLC at +1 203 769 8800 or email info@skyhcm.com