High Yield Market Update

High yield issuers managed the unprecedented decline in economic activity more aptly than expected, which led to a widespread upside earnings surprise for second quarter. Monetary and fiscal policy had continued to provide support for businesses and consumers although the lapsing of direct support during the quarter created some measurable headwinds to continued improvement in economic conditions. Broad-based access to capital, however, has provided a liquidity bridge to a more sustainable recovery for most non-energy-related issuers. Defaults in the Energy sector and, to a lesser extent, Retail-related issuers remain high. Investor concerns shifted towards the US presidential election as the quarter progressed although polls and betting markets have suggested a "Blue Wave" is increasingly likely. Despite weakness late in the quarter, Oil prices rose slightly in Q3 as WTI Crude closed the period up $0.95/bbl (or 2.42%) to $40.22/bbl. For the quarter the US Dollar Index was down 3.51% and Treasuries ended the period with the 2-year down 3 basis points (bps) to 0.13% and the 10-year higher by 3 bp to 0.69% as the yield curve slightly steepened.

Technicals were mixed in the third quarter of 2020 as small inflows were met with heavy new issuance. High yield funds and ETFs had inflows of $3.1bn while loan funds saw continued outflows of $5.3bn, as tracked by Lipper and reported by Barclays. Q3 bond new issuance remained high, pricing $122.1bn in the quarter, offset by $80.0bn of bond redemptions, leaving net supply at $42.1bn for the period, per Barclays. The percentage of the market trading at distressed levels (below 70% of par) ended the quarter at 4.5%; the comparable figure for the loan market (below 80% of par) was 6.6%, per JP Morgan. The par-weighted twelve-month high yield bond default rate increased to 7.2% by quarter-end, per BofA Merrill Lynch. Excluding commodities, the default rate was 4.7%.

The ICE BofA US High Yield Index returned 4.71% in Q3, ending the period with an average price of 99.14, a 4.76-point increase from the prior quarter. Credit spreads tightened by 113 bps to 535 bps and the yield-to-worst (YTW) was lower by 1.17% to 5.70%. High yield outperformed small cap equities, represented by the Russell 2000's 4.60% return, as well as investment grade corporates, as represented by the ICE BofA US Corporate Index's 1.69% quarterly return, but underperformed large cap equities, as represented by the S&P 500's 8.47% return. In high yield, the Double-B, Single-B and Triple-C sub-indices returned 4.17%, 4.60% and 7.68%, respectively. Returns were positive across all sectors for the quarter: the top performer was Leisure, which saw a 7.69% return, while Energy was the bottom-performing sector with a 2.74% return. Small issues ($350m and below) outperformed large issues ($1 billion and above) and longer duration issues outperformed shorter duration issues across risk buckets.

Portfolio Performance

Portfolios managed according to our Unconstrained **Broad High Yield Market Strategy** (BHYM) posted strong relative returns during the third quarter. A number of our key positioning themes played out and portfolios benefited from strong performance from a number of our high conviction holdings. Our bias towards CCC rated issues, small issues, Cyclical issuers and secured credits as well as our underweight to the Energy sector were all generally supportive of outperformance for the quarter. Among our high conviction holdings, Townsquare Media, Avis, KIK Products, Park-Ohio Industries and Surgery Center Holdings were notable outperformers with high conviction holding Triumph Group lower on the quarter due to concern around its ability to continue to improve results in light of current aerospace-related macro headwinds.

SKY Harbor's Unconstrained **Short Duration High Yield Strategy** (SDHY) portfolios posted strong absolute returns again in Q3, capturing about two-thirds of the return of the broader US high yield market (as measured by the ICE BofA US High Yield Index) on a gross-of-fee basis, which is in line with the strategy's historical capture rate. By risk type (defined by yield and duration to worst), the most speculative securities (yielding > 9%), which tend to trade on credit-specific events, outperformed while shortest duration securities lagged. By sector, Leisure and Insurance led while Energy and Banking fell behind although all sectors logged a positive return for Q3. 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 the best risk-adjusted opportunities, which are typically in bonds maturing in 5 years or less and trading with durations of between 2.0 and 3.0.

Portfolio Characteristics

Representative Broad High Yield Market Portfolio

Characteristics	Portfolio[1]	HY Market
Avg Years to Maturity	5.8	6.2
Yield to Worst	6.53%	5.70%
Current Yield	6.93%	6.11%
Duration to Worst	3.3	3.7
OAS	622	535
Avg Coupon	6.97%	6.06%
Number of Issuers	129	833
Number of Issues	166	1995
Average ML Rating	B2	B1
Average Price	100.5	99.1

Distribution by Rating	Portfolio[1]	HY Market
A Holdings	0.0%	0.0%
BBB Holdings	2.1%	0.0%
BB Holdings	22.0%	56.1%
B Holdings	47.5%	32.3%
CCC or Under	28.4%	11.6%

Distribution by Issue Size	Portfolio[1]	HY Market
0 - 250M	9.5%	0.9%
250 - 500M	42.3%	24.1%
500 - 750M	16.6%	22.3%
750 - 1000M	10.3%	16.5%
1000+M	21.3%	36.3%

Distribution by Sector	Portfolio[1]	HY Market	SKY as % of HY Market
Basic Industry	13.5%	10.0%	136%
Capital Goods	13.4%	6.6%	203%
Healthcare	8.8%	9.1%	97%
Technology & Electronics	8.2%	5.1%	161%
Services	8.0%	5.5%	144%
Retail	7.6%	4.9%	156%
Automotive	7.5%	5.2%	145%
Media	7.1%	9.3%	76%
Consumer Goods	6.9%	5.1%	136%
Leisure	6.5%	6.5%	100%
Real Estate	3.5%	2.1%	171%
Transportation	3.2%	1.4%	234%
Telecommunications	2.1%	7.6%	27%
Energy	1.5%	12.5%	12%
Utility	1.2%	2.6%	46%
Financial Services	1.0%	3.7%	28%
Insurance	0.0%	1.1%	0%
Banking	0.0%	1.9%	0%

Top 5 Holdings by Weight	BofA Rating	Issue Size ($mil)	Current Price	BofA Industry	Duration to Worst	Yield to Worst (%)	% of Portfolio
Townsquare Media Inc. 6.500% 01-Apr-2023	B3	280.1	91.63	Media	2.22	10.39	2.30
Great Lakes Dredge & Dock Corp. 8% 15-May-2022	B3	325.0	103.13	Transportation	0.59	3.81	1.92
Vizient Inc. 6.250% 15-May-2027	B2	300.0	105.00	Healthcare	1.50	5.03	1.59
QUAD/GRAPHICS 7.000% 01-May-2022	CCC1	243.5	88.75	Media	1.38	15.21	1.31
BWAY Holding Company 7.250% 15-Apr-2025	CCC2	1,350.0	94.13	Capital Goods	3.63	8.85	1.31

Representative Short Duration High Yield Portfolio

Characteristics	Portfolio[1]	HY Market[2]	SD Universe[3]
Avg Years to Maturity	3.9	6.2	3.4
Yield to Worst	4.61%	5.70%	5.00%
Current Yield	5.98%	6.11%	5.97%
Duration to Worst	1.9	3.7	2.2
OAS	442	535	482
Avg Coupon	6.13%	6.06%	6.02%
Number of Issuers	197	833	424
Number of Issues	273	1995	721
Average Rating	B1	B1	BB3
Average Price	102.37	99.14	100.71

Distribution by Rating	Portfolio[1]	HY Market[2]	SD Universe[3]
A Holdings	0.4%	0.0%	0.0%
BBB Holdings	1.2%	0.0%	0.0%
BB Holdings	38.1%	56.1%	60.2%
B Holdings	49.0%	32.3%	39.8%
CCC or Under	11.4%	11.6%	0.0%

Distribution by Issue Size	Portfolio[1]	HY Market[2]	SD Universe[3]
0 - 250M	4.8%	0.9%	0.1%
250 - 500M	29.3%	24.0%	19.7%
500 - 750M	23.3%	22.2%	27.0%
750 - 1000M	10.9%	16.4%	13.2%
1000+M	31.7%	36.6%	40.0%

Distribution by Sector	Portfolio[1]	HY Market[2]	SD Universe[3]
Basic Industry	11.0%	10.0%	10.8%
Healthcare	9.2%	9.1%	8.0%
Financial Services	9.0%	3.7%	5.2%
Capital Goods	9.0%	6.6%	5.4%
Media	8.9%	9.3%	7.0%
Telecommunications	7.8%	7.6%	5.9%
Technology & Electronics	7.5%	5.1%	4.5%
Real Estate	6.7%	2.1%	3.0%
Automotive	6.6%	5.2%	4.7%
Leisure	6.1%	6.5%	8.8%
Consumer Goods	5.3%	5.1%	4.3%
Services	5.0%	5.5%	4.6%
Retail	4.4%	4.9%	6.1%
Transportation	2.1%	1.4%	3.1%
Insurance	0.7%	1.1%	1.0%
Other	0.4%	0.0%	0.0%
Utility	0.3%	2.6%	1.7%
Banking	0.0%	1.9%	2.2%
Energy	0.0%	12.5%	13.8%

Top 5 Holdings by Weight	Average Rating	Issue Size ($mil)	Current Price	BofA Industry	Duration to Worst	Yield to Worst (%)	% of Portfolio
LPL Holdings Inc. 5.750% 15-Sep-2025	BB3	900.0	103.00	Financial Services	0.45	3.96	0.91
Bausch Health Companies Inc 6.125% 15-Apr-2025	B2	3,250.0	102.37	Healthcare	2.27	5.11	0.89
Kennedy Wilson Inc 5.875% 01-Apr-2024	BB3	1,150.0	99.38	Real Estate	3.12	6.04	0.86
Allied Universal Holdco LLC 6.625% 15-Jul-2026	B2	1,940.0	106.25	Services	1.66	4.59	0.83
BWAY Holding Company 5.500% 15-Apr-2024	B2	1,480.0	100.00	Capital Goods	1.42	5.26	0.82

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, 2020 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 "H0A0" (HY Market) and ICE BofA 1-5 Year BB-B US Cash Pay High Yield Constrained Index "JCV4" (SD Universe).

Outlook

Investor surveys suggest that credit investors have been most focused on the upcoming election, having shifted from a focus on the timing and pace of an economic recovery. Market volatility around election outcome probabilities will increase and risks are likely to reprice themselves according to how well they are expected to fare with different election outcomes. Our positioning is evolved towards sectors where those risks are either over- or under-discounted.

Our central scenario has not changed. We expect rising default risk in the Energy, Retail, Leisure and potentially Transportation sectors despite an eventual stabilization of coronavirus-related impact to demand over time. Defaults away from these key sectors appear to be rapidly declining as markets are willing to bridge many stressed capital structures to the time when end-market demand is sufficiently robust.

Fiscal and monetary stimulus around the globe appears ready to resize and evolve on an as-needed basis and development of both a coronavirus treatment protocol and a vaccine appears likely. Spread compression is likely to continue as a result. We believe the market has excess return opportunity associated with credit picking given the high level of dispersion in the market, and are managing our portfolios with the expectations of improving earnings over the next 12 months.

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