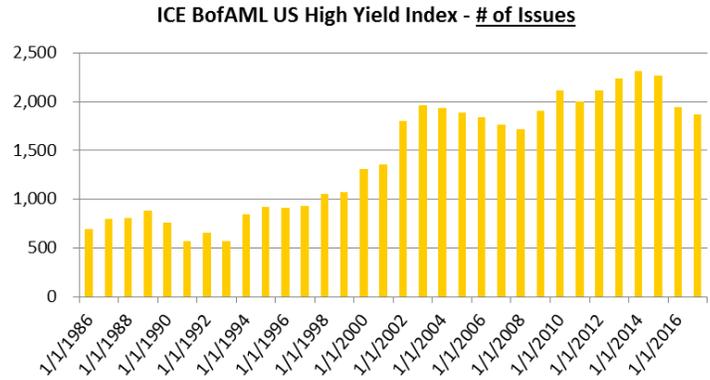
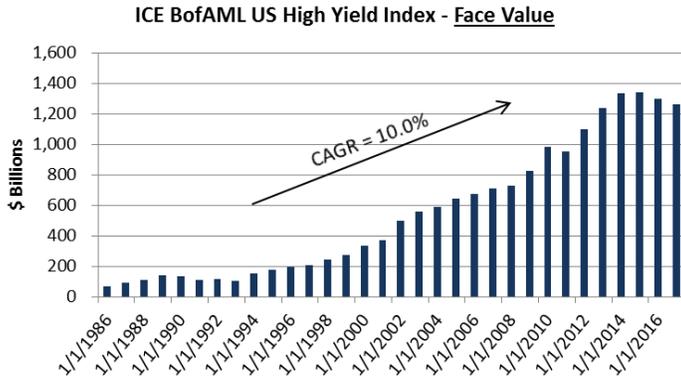


The Case for High Yield

Evolution of the High Yield Market

The US high yield bond market has evolved considerably since its inception, expanding in size and scope over the last several decades. After growing at a compound annual rate of ~10.0% since 1986, the US high yield bond market presently has a face value of approximately \$1.3 trillion, and consists of nearly 1,900 bond issues. Below is a depiction of the market’s evolution over the past 30 years.



Source: SKY Harbor, ICE BofAML US High Yield Index; data as of 10/31/2017

The high yield index is home to many well-regarded and well-known corporations. Over 250 issuers in the ICE BofAML US High Yield Index are also included in the Russell 2000 Index, and over 50 members of the S&P 500 Index are high yield companies. Below is a sample of several globally recognized companies that are within the investable high yield universe:

American Airlines (AAL); LTM Revenue = \$41bn

Charter Communications (CHTR); LTM Revenue = \$41bn

Goodyear Tire & Rubber (GT); LTM Revenue = \$15bn

Fiat Chrysler Automobiles (FCA); LTM Revenue = €112bn

Hilton Worldwide Hldgs (HLT); LTM Revenue = \$10bn

Alcoa (AA); LTM Revenue = \$11bn

Netflix (NFLX); LTM Revenue = \$11bn

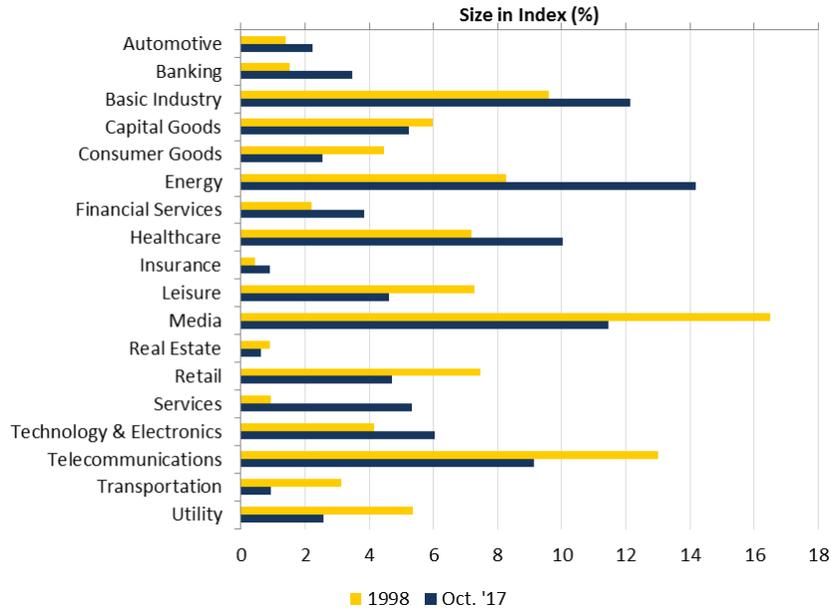
T Mobile (TMUS); LTM Revenue = \$40bn

Fresenius Medical Care; LTM Revenue = \$20bn

Post (POST); LTM Revenue = \$5bn

Source: SKY Harbor, company filings, Bloomberg, ICE BofAML US High Yield Index

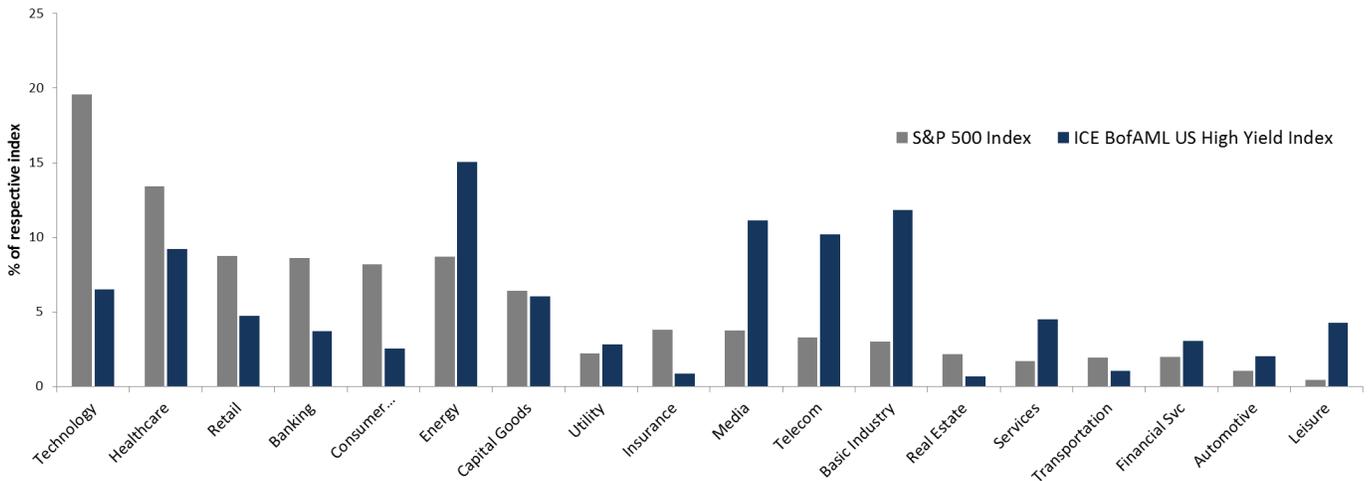
Sector diversification has improved steadily over the past 20 years. As demonstrated below, some of the largest sectors in the high yield index circa 1998 have decreased in size (namely Media and Telecommunications), while Basic Industries, Energy, Healthcare and Technology have increased. Below is a snapshot of this evolution:



Source: SKY Harbor, ICE BofAML US High Yield Index

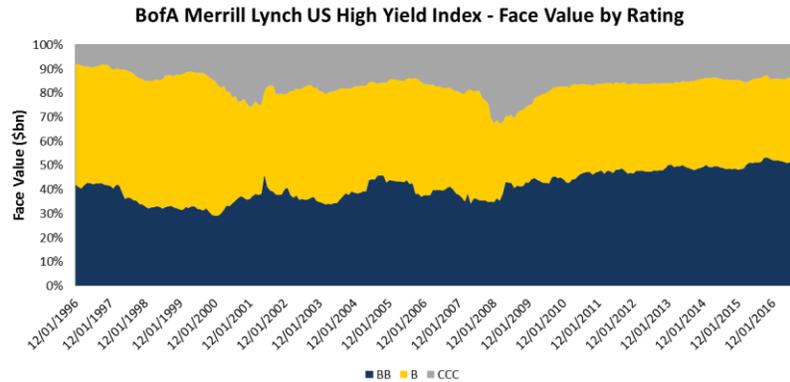
When compared to the S&P 500 Index, the high yield universe affords investors greater opportunity for sector diversity. Technology and Healthcare have a disproportionately large impact on the S&P 500, for example, whereas the disparity in size between the largest and smallest sectors within the high yield space is less pronounced.

	S&P 500 Index Weights	ICE BofAML US High Yield Index Weights
Top Constituent	4.0% (Apple)	1.9% (Sprint)
Top 10 Constituents	20.1%	12.8%
Top Sector	24.5% (Information Technology)	14.2% (Energy)
Top 3 Sectors	53.3% (Info. Tech., Financials, Health Care)	37.8% (Energy, Basic Ind., Media)



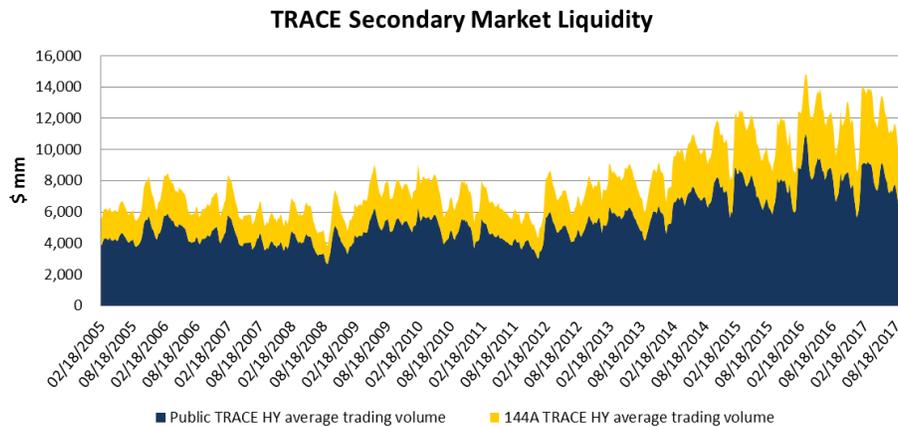
Source: SKY Harbor, ICE BofAML US High Yield Index, Bloomberg

On a face-value-weighted basis, the US high yield market is predominantly made up of Double-B and Single-B rated issuers. Going back to the mid-1990s, our research shows that approximately 42% of issues have been BB rated, 42% of issues have been B rated, and 17% of issues have been CCC rated or lower. While the relative weights vary over time, all ratings buckets have maintained a large and diversified set of options for investors depending on their risk profiles. Currently, the BB portion of the index is larger than normal, mainly due to an influx of fallen angels in 2016 and positive ratings migration rates over the last 12 months. Below is a graph that displays the evolution of ratings in the high yield index over time.



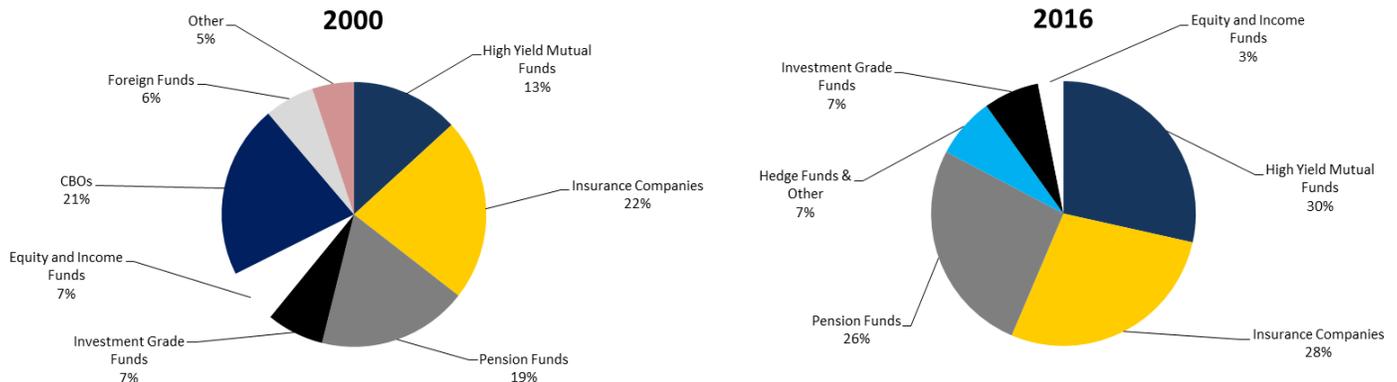
Source: SKY Harbor, ICE BofAML US High Yield Index

Secondary market liquidity, in absolute dollars, has been on the rise. Using public and 144A private placement TRACE high yield volumes, weekly trading equates to ~1.0% of total debt outstanding, modestly better than the 0.96% weekly average from 2005 through 2010, and better than the 0.77% weekly average from 2010 to present.



Source: SKY Harbor, BofA Merrill Lynch. Trade Reporting and Compliance Engine (TRACE) is administered by the Financial Industry Regulatory Authority (FINRA) and is the primary industry source for historical over-the-counter (OTC) secondary market bond transaction information.

There has also been evolution in the holder base of high yield bonds. In 2000, insurance companies and collateralized bond obligations (CBOs) were the largest holders of high yield debt, at 22% and 21%, respectively. By year-end 2016, CBOs had essentially disappeared, with insurance companies, pension funds and high yield mutual funds growing their respective market shares. This evolution is shown below:



Source: SKY Harbor, JP Morgan

Low Correlation to Treasuries and Other Asset Classes

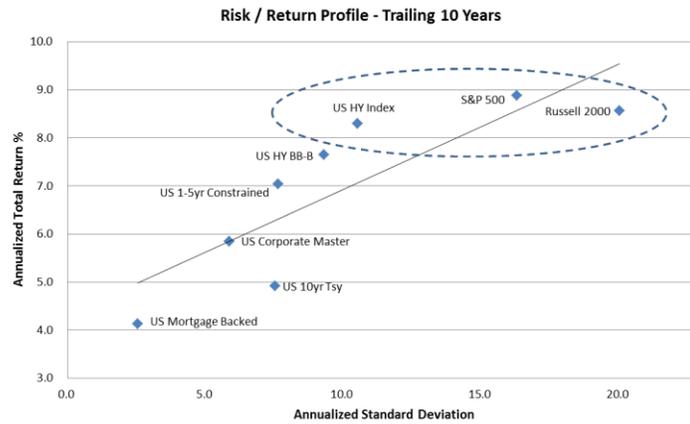
On an historical basis, high yield has demonstrated low correlation to other asset classes, leading to benefits of diversification within a portfolio of investments. Unlike other fixed income asset classes such as investment grade corporates, emerging market sovereign debt and US mortgage-backed securities, high yield has demonstrated a negative correlation to the 10-yr US Treasury (-0.22 over the last ten years), as illustrated in the table below. All other things being equal, the high yield asset class may be better positioned to weather a period of rising interest rates relative to other fixed income options.

Asset Class Correlation Matrix - 10 Years
(monthly returns through Oct. '17)

Ticker	Index Name	US Treasury Current 10yr	Credit Suisse US Leveraged Loan Index	ICE BofAML US High Yield Index	ICE BofAML BB-B US High Yield Index	ICE BofAML 1-5 Year BB-B US Cash Pay High Yield Constrained Index	ICE BofAML US Corporate Index	ICE BofAML Emerging Markets External Debt Sovereign Index	ICE BofAML US Mortgage Backed Securities Index	Standard & Poor's 500	Russell 2000
GA10	US Treasury Current 10yr	1.00									
LEVLOAN	Credit Suisse US Leveraged Loan Index	(0.43)	1.00								
HOA0	ICE BofAML US High Yield Index	(0.22)	0.85	1.00							
HOA4	ICE BofAML BB-B US High Yield Index	(0.21)	0.84	0.99	1.00						
JVC4	ICE BofAML 1-5 Year BB-B US Cash Pay High Yield Constrained Index	(0.23)	0.87	0.98	0.99	1.00					
COA0	ICE BofAML US Corporate Index	0.43	0.44	0.66	0.68	0.65	1.00				
EMGB	ICE BofAML Emerging Markets External Debt Sovereign Index	0.27	0.51	0.75	0.76	0.75	0.81	1.00			
MDOA	ICE BofAML US Mortgage Backed Securities Index	0.80	(0.16)	0.02	0.05	0.05	0.54	0.47	1.00		
SPXT	Standard & Poor's 500	(0.27)	0.56	0.67	0.64	0.62	0.34	0.52	(0.13)	1.00	
RTY	Russell 2000	(0.38)	0.56	0.69	0.65	0.64	0.26	0.45	(0.23)	0.83	1.00

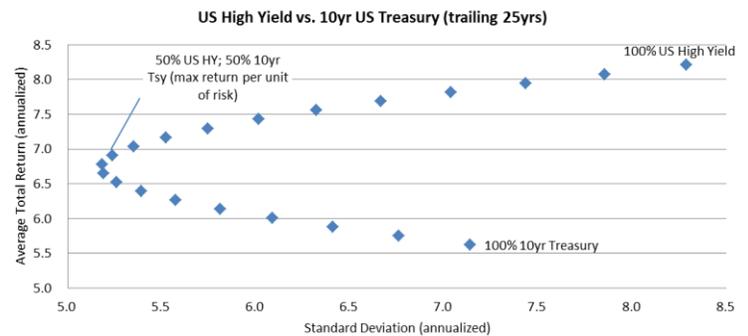
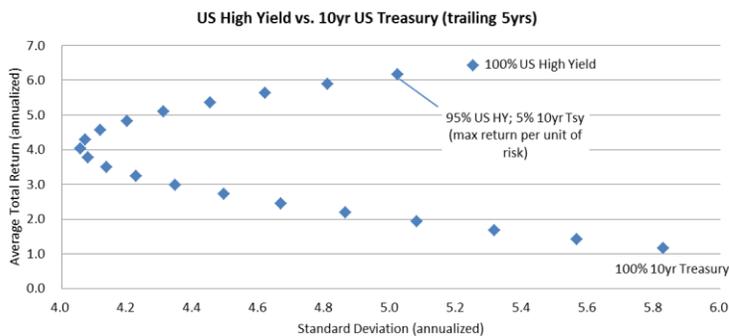
Source: SKY Harbor, ICE BofAML, Credit Suisse Bloomberg

When compared to an equity portfolio (we use the S&P 500 and Russell 2000 indices as large and small cap proxies), high yield has historically provided similar returns with materially less volatility. In the chart below, we plot the annualized total returns and standard deviations of various asset classes over a ten-year period, including US equities (S&P 500, Russell 2000), a broad high yield index (ICE BofAML US High Yield Index), a constrained high yield index (ICE BofAML BB-B US High Yield Index), and a short duration constrained index (ICE BofAML 1-5 Year BB-B US Cash Pay High Yield Constrained Index).



Source: SKY Harbor, ICE BofAML US High Yield Index, Bloomberg

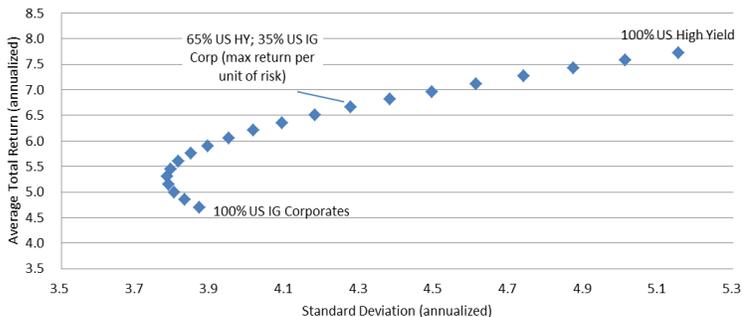
Because of the relatively low correlation to other asset classes, high yield bonds can potentially improve the risk and return profile of a portfolio of Treasuries and investment grade corporates. These benefits of diversification are evident in the following analysis. The chart below depicts annualized total returns and standard deviations of a hypothetical portfolio of US Treasuries (10-yr) and the ICE BofAML US High Yield Index, moving in 5% increments (from 100% Treasuries to 100% High Yield). Using data sets that include rolling 5- and 25-year returns, we find that adding high yield to a portfolio of US Treasuries would have improved returns and reduced volatility.



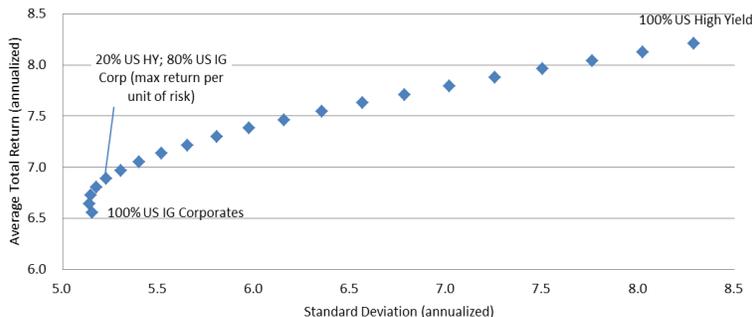
Source: SKY Harbor, ICE BofAML US High Yield Index

Below, we repeat this exercise using investment grade corporate bonds (ICE BofAML US Corporate Index) and high yield (ICE BofAML US High Yield Index). Similar to results with Treasuries, adding high yield serves to improve overall return per unit of risk metrics on a portfolio.

US High Yield vs. US Investment Grade Corporates (trailing 5ys)



US High Yield vs. US Investment Grade Corporates (trailing 25yrs)



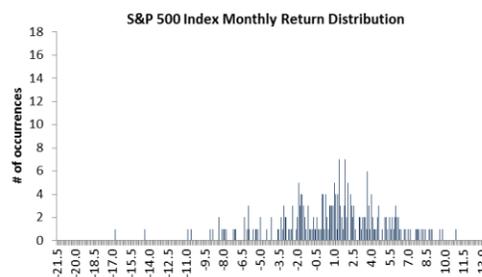
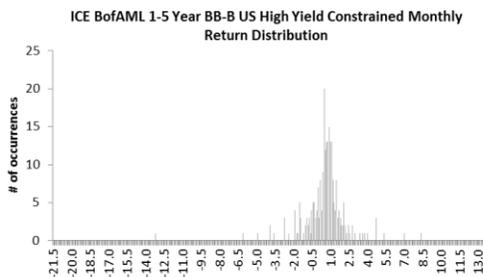
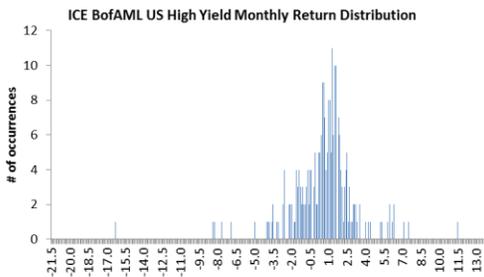
Source: SKY Harbor, ICE BofAML

Consistency of Returns

For investors who seek to minimize volatility and achieve a more consistent set of monthly returns over time, high yield also stacks up favorably in comparison to equities. The analysis below measures monthly returns of the broad high yield index (ICE BofAML US High Yield Index), a short duration constrained index (ICE BofAML 1-5 Year BB-B US Cash Pay High Yield Constrained Index) and US equities (S&P 500 Index). We use data going back to 1997, as this was the date of inception of the constrained short duration high yield index. As shown below, both high yield indices provide more consistent returns with fewer negative total return months.

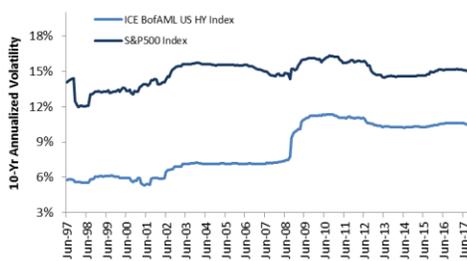
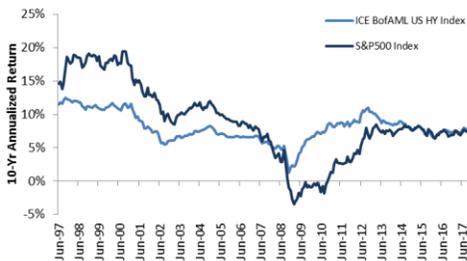
Jan. '97 to Oct. '17

	Broad HY	Short Dur. HY	S&P 500
Average Monthly Return	0.60	0.56	0.75
Number of monthly observations	250	250	250
Number of zero or positive months	173	190	161
Number of negative months	77	60	89
% of positive months	69%	76%	64%



Source: SKY Harbor, ICE BofAML, Bloomberg

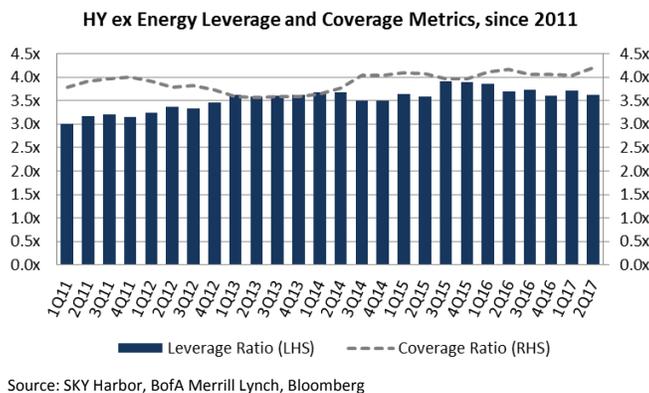
Using the same time period, we see that the broad high yield index has provided similar total returns as the S&P 500 Index, all while demonstrating lower volatility (measured by standard deviation of returns) and greater efficiency (measured by return per unit of risk).



Source: SKY Harbor, ICE BofAML US High Yield Index, Bloomberg

Credit Fundamentals

Fundamentals have been the cause of widespread disagreement among sell-side institutions, particularly as leverage – the most often used measure of credit quality – can vary tremendously depending on each investor’s interpretation of EBITDA adjustments and the exclusion of certain sectors given idiosyncratic risks. Following extraordinary events that have occurred in the Energy sector over the last three years, we believe the appropriate way to view index-wide leverage is to exclude those credits, as stress that has now been overcome can distort metrics in the recent past. Using data through Q2’17 (not all credits have reported Q3’17 results as of the time of publication), we find that leverage has improved to ~ 3.6x, as shown below:

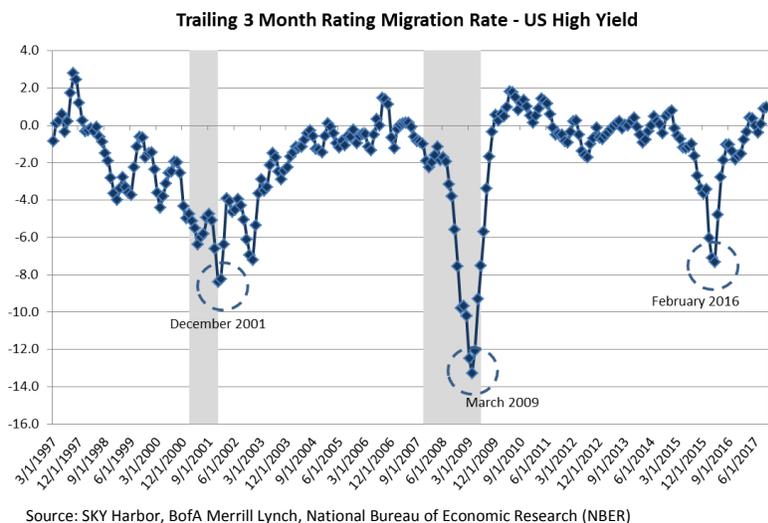


While we would concede that leverage is at the higher end of the range of values we have observed since the recovery began in July ‘09 (cycle average is lower, or ~ 3.4x), we would also note that relatively strong new issue market conditions, as well as historically low interest rates, have allowed average interest coverage ratios to rise (now above cycle averages). As a result, interest expense has become much more manageable, despite somewhat higher debt balances, and has allowed for improved free cash flow generation. Furthermore, to the extent that investors focus on credit metrics as a way to predict the potential for future stress on the index, most notably through increased defaults, we highlight that interest coverage has exhibited a higher degree of correlation to ultimate default rates than has debt leverage (i.e., we should be more focused on stronger-than-average interest coverage than we are on weaker-than-average debt leverage).

Earnings growth for S&P 500 constituents is also trending positively and, according to FactSet, is expected to remain so through 2018. Our internal analysis suggests this positive earnings growth rate expectation for the S&P 500 should translate into positive growth for high yield companies, given an historical earnings growth correlation coefficient of 83%.

Ratings Migration

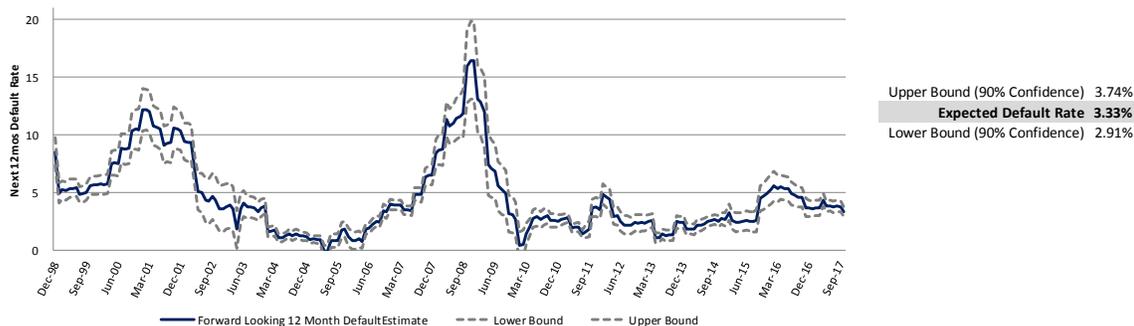
While we would argue that security downgrades by the rating agencies often lag market perception, we acknowledge the potentially negative technical implications, and more onerous capital charges facing some investors. As such, we actively monitor ratings trends. As demonstrated below, negative migration rates hit a most recent low in February 2016, with downgrade ratios on par with levels achieved only in prior recessions (shaded in gray). However, the migration rate has since neutralized and turned positive over the last several months, leading to what we believe will be reduced downgrade risk over the next several quarters.



Default Environment

The risk of default, and ultimately of principal loss, is central to gauging risk premiums in the high yield market. 2016 was a year in which the US high yield index experienced a material uptick in defaults. In particular, and on a par-weighted basis, defaults peaked at 5.5% (October 2016), above the long-run average of ~4.2%. This marked the first time in our data set (going back to 1998) in which the trailing rate exceeded the long-run average outside of a recession (aside from a short period in 2006). In 2017, we saw the default rate drop materially, with a most recent reading of 1.5% at the end of October 2017.

On an issuer-weighted basis, we have seen similar improvements. After a most recent peak of 7.1% in January 2017, the rate has consistently trended downward, with a most recent reading of 3.4% at the end of October. Using our SKY Harbor Default Regression Model, which incorporates the distress ratio, the lending index and a measure of fallen angels to drive projections, our 12-month forward-looking issuer default estimate is ~ 3.3%.



Source: SKY Harbor, BofA Merrill Lynch, Moody's, and Bloomberg

Key Macro Drivers Trending Positively

Key drivers of high yield spreads remain healthy, in our view, and have been trending in a positive direction over the last couple of months. Our proprietary SKY Harbor macro model – a multi-variable regression used to predict fair value high yield market spreads – has tightened nearly every month so far in 2017. Improvements in the St. Louis Federal Reserve Bank Financial Stress Index and the ISM Manufacturing PMI Index, two key variables in the model, have driven the majority of the implied improvement.

Index	Ticker	Proxy	Historical R ²	Key Variables
ICE BofA Merrill Lynch US High Yield Index (ex Energy)	HOAO	Broad HY	92.0%	St. Louis Fed Stress Index, Capacity Utilization, US Industrial Production, ISM PMI
ICE BofA Merrill Lynch US High Yield Index (only Energy)	HOEN	HY Energy	81.4%	VIX Index, Capacity Utilization, US Industrial Production, Rig Counts
ICE BofAML 1-5 Year BB-B US Cash Pay High Yield Constrained Index	JVC4	Short HY	88.1%	VIX Index, Cap Utilization, US Industrial Production, Senior Loan Officer Survey, Eco Policy Uncertainty Composite Index

Source: SKY Harbor, ICE BofAML, Bloomberg

Performance during Periods of Rising Rates and Rising Volatility

Over the next year, we believe the primary risks to the market include rising volatility and an upward trajectory of interest rates. Using a data set that goes back to January '00, we calculated average monthly returns and the standard deviation of those returns under the aforementioned scenario. Below is a summary of our findings: when using all periods, the full high yield index (HOAO) offers the most favorable average monthly returns. In periods of both increased volatility (as defined by periods in which VIX volatility index rises relative to the prior month) and rising rates (as defined by periods in which yields on the US 5yr Treasury rise relative to the prior month), the short duration constrained index (JVC4) offers the highest average monthly return and lowest standard deviation of returns. Investment grade corporate credit (COAO) and equities (SPX) provide the weakest absolute and risk-adjusted returns.

Monthly Return Analysis - by Index

		ICE BofAML 1-5 Year BB-B US Cash Pay				
		ICE BofAML US High Yield Index HOAO	ICE BofAML BB-B US High Yield Index HOA4	High Yield Constrained Index JVC4	ICE BofAML US Corporate Index COAO	Standard & Poor's 500 Index SPX
All Periods Since 2000 (214 Monthly Periods)	Avg. Returns	0.619	0.577	0.571	0.510	0.513
	St. Dev. Of Returns	2.704	2.424	1.886	1.538	4.203
	Return per Unit of Risk	0.229	0.238	0.303	0.331	0.122
Rising Rates & Rising Vix Periods (36 Monthly Periods)	Avg. Returns	0.049	0.071	0.266	(0.491)	(0.950)
	St. Dev. Of Returns	1.970	1.937	1.609	0.983	2.836
	Return per Unit of Risk	0.025	0.037	0.166	(0.500)	(0.335)

Source: SKY Harbor, ICE BofAML, Bloomberg

Key Takeaways

- The high yield market has grown materially over the last several decades, and now represents a much larger and more diversified asset class.
- The high yield universe contains many globally recognized corporations, with significant overlap with the Russell 2000 and S&P 500 indices.
- The high yield index is well diversified across sectors (arguably more so than the S&P 500) and by rating.
- Liquidity has improved in the secondary market.
- The high yield investor base has evolved materially over the last decade, with high yield mutual funds, insurance companies and pension funds now the most sizable investors.
- High yield has historically exhibited low correlations to other asset classes, leading to material benefits from diversification.
- High yield has historically exhibited negative correlations to US Treasuries, leading to a more favorable position than other fixed income products in periods of rising rates.
- High yield has historically maintained a more attractive risk/return profile relative to both equities and investment grade credit.
- Since 1997 high yield has generated more consistent monthly returns than equities (as represented by the S&P 500), with materially fewer negative return months.
- In our view, high yield credit fundamentals have stabilized, and look relatively attractive from a coverage ratio perspective.
- Ratings migration rates have recovered from recession-like conditions in Q1'16, with materially diminished downside risk.
- Based on our internal model, we believe the high yield default rate will remain below long-run averages through 2018.
- Key macro drivers have been trending positively, which should be supportive of high yield spreads as implied by our regression model.
- Various high yield options (broad market, constrained broad market and short duration) can be used to effectively position portfolios for prominent risks heading into 2018.
- In general, we believe the high yield asset class occupies an attractive niche for asset allocators given a greater return potential relative to investment grade corporates and similar returns with lower volatility relative to equities.

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