First State Investments

# FIRST STATE INVESTMENTS HIGH YIELD

## Quarterly Update

High Yield
Q4 2019

***"It is not the responsibility of the Federal Reserve – nor would it be appropriate – to protect lenders and investors from the consequences of their financial decisions"***
– Dr. Ben Bernanke, August 17, 2007

***"Without big banks, socialism would be impossible."***
– Vladimir Lenin, October 14, 1917

## Thoughts on the Market

The US High Yield market, as represented by the ICE BofAML US High Yield Constrained Index (HUC0) posted a 2.6% Q419 total return (TR), and a 14.4% TR for the full-year. The strong 2019 represented the fourth best annual return since the post-Global Financial Crisis (GFC) recovery in 2009; modestly trailing the 17.5%, 15.6% and 15.1% total returns of 2016, 2012 and 2010, respectively.

In the fixed income markets during Q419, a prominent trend reversal was the sell-off in US Treasuries (UST). Exhibit 1, below highlights weakness in the UST 10-Year, which reflects a 25 bps increase in yield. Investment Grade corporates (IG), as represented by the ICE BofAML US Corporate Index (C0A0) proved extremely resilient in the face of higher rates: the 1.15% TR.

The spread-to-worst (STW) of the IG Index tightened 21 bps during the quarter, to a STW of 99 bps, versus a post-GFC tight of 88 bps on 2 February 2018. US and Emerging Market equities traded higher throughout the quarter, seemingly boosted by any and all accommodative monetary actions, or statements by the Global Central Banks (GCBs). From the perspective of a 30+ year veteran, (and long ago, value equity PM) there seems to be two simple ingredients to ever higher, record-high, stock markets: ▶ unlimited money printing, and ▶ unlimited conviction that game theory favours a no-price-too-high wager on the GCB-put. A Brave New World?

Meanwhile, US High Yield (HY) presented a very interesting dichotomy in October and November, relative to the "one-way, up" equity markets. The US Broad HY market, as represented by the ICE BofAML US High Yield Constrained Index (HUC0) experienced -52 bps in price decline during October-November, but posted a solid 2.61% total return for Q419; after a 157 bps price increase in December, and 166 bps of income for the quarter. Interestingly, while CCC US HY (HUC3) posted the strongest, 3.43% total return of the three, rating-based tranches during Q419, in comparison to other periods where the lowest quality credits historically have lagged to the other two rating-based tranches.

### Exhibit 1: Returns of Various Assets

| Asset Class | 2019 | Q4 19 | Q3 19 | Q2 19 | Q1 19 | 2018 | 3-Yrs '19 |
|---|---|---|---|---|---|---|---|
| S&P 500 | 31.48% | 9.06% | 1.70% | 4.30% | 13.65% | -4.39% | 15.25% |
| Emerging Market Stocks | 18.63% | 11.74% | -4.13% | 0.73% | 9.94% | -14.28% | 11.89% |
| 10-Year US Treasury | 8.91% | -1.77% | 3.18% | 4.23% | 3.10% | -0.03% | 3.58% |
| Investment Grade Corp | 14.23% | 1.15% | 3.07% | 4.35% | 5.01% | -2.25% | *5.95%* |
| US High Yield Corp Bonds | 14.41% | 2.61% | 1.22% | 2.57% | 7.40% | -2.27% | 6.33% |
| Euro High Yield Corps | 11.29% | 1.98% | 1.30% | 2.33% | 5.28% | -3.63% | 4.62% |
| EM High Yield Corps | 13.49% | 4.15% | -0.27% | 3.08% | 5.98% | -2.29% | *6.45%* |
| US High Yield by Rating | | | | | | | |
| BB US High Yield Corps | 15.74% | 2.39% | 2.05% | 3.17% | 7.36% | -2.57% | 6.55% |
| B US High Yield Corps | 14.26% | 2.89% | 1.11% | 2.31% | 7.35% | -1.72% | 6.27% |
| CCC US High Yield Corps | 9.56% | 3.43% | -2.38% | 0.58% | 7.89% | -4.91% | 4.42% |

Source: JP Morgan, ICE BAML

**RISK FACTORS**

This document is a financial promotion for The First State High Yield Strategy. This information is for professional clients only in the EEA and elsewhere where lawful. Investing involves certain risks including:

- **The value of investments and any income from them may go down as well as up and are not guaranteed. Investors may get back significantly less than the original amount invested.**
- **Currency risk:** Changes in exchange rates will affect the value of assets which are denominated in other currencies.
- **Credit risk:** The issuers of bonds or similar investments may not pay income or repay capital when due.
- **Interest rate risk:** Interest rates affect the value of investments; if rates go up, the value of investments fall and vice versa.
- **Below investment grade risk:** Below investment grade debt securities are speculative and involve a greater risk of default and price changes than investment grade debt securities due to changes in the issuer's creditworthiness. In periods of general economic difficulty, the market prices may fluctuate and decline significantly.

Reference to specific securities or companies (if any) are included to explain the investment strategy and should not be construed as investment advice, or a recommendation to invest in any of those companies.

There are currently no investment funds available for this strategy in the EEA. Please contact your sales representative for more details.

**If you are in any doubt as to the suitability of our funds for your investment needs, please seek investment advice.**

## Discrete Annual Performance Summary

| Asset Class | 12 mths to 31/12/19 | 12 mths to 31/12/18 | 12 mths to 31/12/17 | 12 mths to 31/12/16 | 12 mths to 31/12/15 |
|---|---|---|---|---|---|
| S&P 500 | 31.49% | -4.38% | 21.83% | 11.96% | 1.38% |
| Emerging Market Stocks | 18.42% | -14.57% | 37.28% | 11.19% | -14.92% |
| 10-Year US Treasury | 8.91% | -0.03% | 2.07% | -0.16% | 0.91% |
| Investment Grade Corp | 14.23% | -2.25% | 6.48% | 5.96% | -0.63% |
| US High Yield Corp Bonds | 14.41% | -2.26% | 7.48% | 17.49% | -4.64% |
| Euro High Yield Corps | 11.29% | -3.63% | 6.74% | 9.07% | 0.76% |
| EM High Yield Corps | 13.39% | -2.55% | 9.66% | 17.11% | 2.29% |
| BB US High Yield Corps | 15.74% | -2.57% | 7.25% | 13.44% | -1.17% |
| B US High Yield Corps | 14.26% | -1.72% | 6.86% | 16.66% | -4.74% |
| CCC US High Yield Corps | 9.56% | -4.91% | 9.26% | 37.70% | -15.45% |

*Source: MSCI, JP Morgan, ICE BAML, S&P*

Finally, European HY and EM HY Corporates were spared the October-November price weakness of US HY. EM HY Corporates posted a stand-out 4.15% TR in Q419, to only trail US HY by -92 bps in 2019. European HY noticeably lagged US HY by -63 bps in Q419, and -315 bps for all of 2019. However, most of the European HY lag is due to income returns ~60% below US HY.

'NIRP' (negative interest rates policy) hasn't been kind to average coupons of European HY.

# High Yield Market Commentary

The US HY market posted a 2.6% Q419 total return, and 14.4% for the year.

For the overall High Yield market, accounting for the relative weights of industry sectors:

The strongest performing industry sectors in Q419 were Energy, Healthcare, and Telecommunications. The weakest performing sectors for the overall market were Leisure, Hotels, and Media.

The strongest performing industry sectors for all of 2019 were Healthcare, Telecommunications, and Cable TV. The weakest performing sectors for the overall market were Airlines, Entertainment, and Publishing.

For Q419, the BB, SingleB and CCC & Below rated tranches improved in performance as average rating declined, with total returns of 2.39% for BB, 2.89% for SingleB and 3.43% for CCC & Below.

The inverse relationship was evident for full year 2019, with total returns of 15.74% for BB, 14.26% for SingleB and a distant 9.46% for CCC & Below. The CCC & Below tranche was barely price return positive for 2019, with 95% of its total return from income.

# Summary:

The US HY Index characteristics at the end of Q319 and Q419:

**As of 30 September 2019:**
Yield-to-worst of 5.87%, spread-to-worst of 420 bps, duration-to-worst of 3.3, and average price of 99.16

**As of 31 December 2019:**
Yield-to-worst of 5.41%, spread-to-worst of 372 bps, duration- to-worst of 3.0, and average price of 100.74

## High Yield Composite Gross Performance - Annualized

| As of 31 December 2019 | | | | | | | | *Inception 30 April 2017* |
|---|---|---|---|---|---|---|---|---|
| | 2019 | Q419 | Q319 | Q219 | Q119 | 12 mths to 31/12/2019 | 12 mths to 31/12/2018 | Since Inception |
| **Broad High Yield** | **16.09%** | **2.72%** | **2.07%** | **3.01%** | **7.49%** | **16.09%** | **-1.62%** | **6.72%** |
| ICE BofAMLUS HY ConstIdx | 14.41% | 2.61% | 1.22% | 2.56% | 7.40% | 14.41% | -2.27% | 5.62% |
| ActivePerformance | 1.68% | 0.11% | 0.85% | 0.45% | 0.09% | 1.68% | 0.65% | 1.10% |
| **Select High Yield** | **16.55%** | **2.78%** | **2.01%** | **3.06%** | **7.86%** | **16.55%** | **-2.06%** | **6.69%** |
| ICE BofAMLUS HY ConstIdx | 14.41% | 2.61% | 1.22% | 2.56% | 7.40% | 14.41% | -2.27% | 5.62% |
| ActivePerformance | 2.14% | 0.18% | 0.78% | 0.49% | 0.46% | 2.14% | 0.21% | 1.07% |
| **Quality High Yield** | **15.75%** | **2.68%** | **2.12%** | **2.97%** | **7.20%** | **15.75%** | **-1.34%** | **6.72%** |
| ICE BofAMLBB-B US HY ConstrIdx | 15.10% | 2.58% | 1.68% | 2.82% | 7.34% | 15.10% | -2.04% | 5.90% |
| ActivePerformance | 0.64% | 0.11% | 0.45% | 0.15% | -0.14% | 0.64% | 0.71% | 0.83% |
| **Short Duration High Yield** | **10.84%** | **2.12%** | **1.37%** | **1.76%** | **5.22%** | **10.84%** | **0.53%** | **5.22%** |
| ICE BAM 1-5 YR BB-B US Cash Pay HY Idx | 10.98% | 2.04% | 1.20% | 1.88% | 5.49% | 10.98% | 0.67% | 5.26% |
| ActivePerformance | -0.14% | 0.08% | 0.17% | -0.12% | -0.27% | -0.14% | -0.15% | -0.04% |

First State Investments as at December 2019. The Inception Date of the FSI High Yield Composites was May 1, 2017. Past performance is not a reliable indicator of future performance. The assets within the FSI Select High Yield Composite and the FSI Quality High Yield Composite have been combined to create the FSI Broad High Yield Composite. Composite returns are gross of fees in USD. Performance figures do not reflect the deduction of investment advisory fees, commissions and other charges. Note: due to rounding percentages may not precisely reflect the absolute figures.

## High Yield Composite Net Performance - Annualized

| As of 31 December 2019 | | | | | | | | *Inception 30 April 2017* |
|---|---|---|---|---|---|---|---|---|
| | 2019 | Q419 | Q319 | Q219 | Q119 | 12 mths to 31/12/2019 | 12 mths to 31/12/2018 | Since Inception |
| **Broad High Yield** | **15.63%** | **2.62%** | **1.97%** | **2.91%** | **7.39%** | **15.63%** | **-2.01%** | **6.30%** |
| ICE BofAMLUS HY ConstIdx | 14.41% | 2.61% | 1.22% | 2.56% | 7.40% | 14.41% | -2.27% | 5.62% |
| ActivePerformance | 1.22% | 0.01% | 0.74% | 0.34% | -0.02% | 1.22% | 0.25% | 0.67% |
| **Select High Yield** | **16.08%** | **2.68%** | **1.91%** | **2.96%** | **7.75%** | **16.08%** | **-2.45%** | **6.27%** |
| ICE BofAMLUS HY ConstIdx | 14.41% | 2.61% | 1.22% | 2.56% | 7.40% | 14.41% | -2.27% | 5.62% |
| ActivePerformance | 1.67% | 0.07% | 0.68% | 0.39% | 0.35% | 1.67% | -0.18% | 0.64% |
| **Quality High Yield** | **15.28%** | **2.58%** | **2.02%** | **2.86%** | **7.09%** | **15.28%** | **-1.73%** | **6.30%** |
| ICE BofAMLBB-B US HY ConstrIdx | 15.10% | 2.58% | 1.68% | 2.82% | 7.34% | 15.10% | -2.04% | 5.90% |
| ActivePerformance | 0.18% | 0.00% | 0.34% | 0.05% | -0.25% | 0.18% | 0.31% | 0.40% |
| **Short Duration High Yield** | **10.40%** | **2.02%** | **1.27%** | **1.66%** | **5.11%** | **10.40%** | **0.13%** | **4.80%** |
| ICE BAM 1-5 YR BB-B US Cash Pay HY Idx | 10.98% | 2.04% | 1.20% | 1.88% | 5.49% | 10.98% | 0.67% | 5.26% |
| ActivePerformance | -0.58% | -0.02% | 0.07% | -0.22% | -0.38% | -0.58% | -0.55% | -0.46% |

First State Investments as at December 2019. Composite inception date is 1 May 2017. Shown as net of fees in USD, deducting institutional share class fees (AMC: 0.40%). The assets within the FSI Select High Yield Composite and the FSI Quality High Yield Composite have been combined to create the FSI Broad High Yield Composite. These figures refer to the past. Past performance is not a reliable indicator of future results.

## Portfolio Positioning

The industry sectors producing the biggest impacts within our High Yield Composites are often very different than the overall market, due to our individual credit overweight's and cumulative bond picking results.

For our Broad High Yield Composite, the sectors making the strongest contributions to performance for Q419 were Services, (e.g. GEO Group), Consumer Products, (e.g. Vista Outdoor) and Energy, (e.g. Laredo Petroleum).

Conversely, the sectors making the weakest contributions to performance included Metals/Mining Ex-Steel, Retail, (e.g. GrubHub) and Financial (due to our 5.1% underweight relative to the index).

For our Broad High Yield Composite during 2019, the sectors making the strongest contributions to performance, were Energy, Consumer Products and Telecommunications. Energy performance was the result of superior security selection in Exploration & Products (E&P), and a combination of solid security selection and a meaningful underweight in Energy Services.

Telecommunications performance benefited from four holdings, in particular: a global communications satellite operator; structurally senior debt at an underleveraged subsidiary of CenturyLink; an asset rich wireless provider based in Chicago; one of the largest high yield issuers that we expect to successfully merge with T-Mobile US.

Conversely, the sectors making the weakest contributions to performance for the year, included Financial (due to our average 5.9% underweight relative to the index), Retail and Utility.

Our team became relatively active in the portfolios during the second half of the year as the US high yield market was "sneaky" soft from July-November; with each month experiencing small benchmark index price declines. November was a particularly busy month with a heavy bias toward net buying. We bought only a few new issues during Q419, and one of those was a new issue Term Loan. We added four new Term Loan holdings as weakness in that market segment presented select buying opportunities. Our E&P exposure was actively traded based on relative value, and net exposure increased, as bond prices lagged the run-up in West Texas Intermediate crude prices during November-December. Other notable trends included a concerted effort to decrease, and exit exposure to select Metals/Mining credits; while increasing our weights in some of our Telecommunications holdings. As always, all of our portfolio changes were simply the result of our team letting our investment process highlight potential portfolio changes, and then, agreeing on the proper course to maintain optimal, default-adjusted portfolios.

Big picture, our investment process currently leads us to be overweight Consumer Products, Energy-E&P (largely offset by underweights in Energy Services), and Pharmaceuticals (largely offset by an underweight in Healthcare Facilities). Our constant, and largest sector underweights remains Financial. Our other meaningful underweight is Media, which includes Advertising, Cable TV and Media Content.

All four of our High Yield Composites outperformed their benchmark indexes during Q419. Broad High Yield, Select High Yield, and Quality High Yield have also outperformed in 2019 and Since Inception. Just 3 months from our 3 year, performance milestone, our investment process has delivered strong results.

Short Duration High Yield has modestly lagged (-4 bps)* its benchmark index Since Inception, however we are satisfied with performance given the strategy's emphasis on relative safety and low volatility.

## Other Views

### Our "Swan Song" Analysis of Global Central Banks:

We reluctantly share out thoughts regarding the highest profile, macro dynamic during the quarter. We'll preface our comments by admitting our views are based on common sense, rather than first-hand, knowledge, or even expertise regarding the latest area of increased GCB mania. As backdrop, the Fed officially began cutting the discount rate on 31 July 2019, having verbally performed its 180° dovish U-turn in mid-January, a full year prior to this investor letter.

At market close on 13 September 2019: the HY Index offered a 5.82% YTW and 397 bp STW, trading towards the tight end of its STW range; the NASDAQ 100 had been trading "range bound" since the end of April; interestingly, the 10-Yr UST bond's yield had increased from its 2019 low of 1.46%, to 1.90% in just the previous 8 trading days, (an ~4 pt. decline). Still, just another week during the great bull market.

The following week, the typically sedate "repo rate" shook the foundation of the financial markets when it soared from ~2%, to as high as 9%, on 17 September 2019. The repo market has most commonly served as a source of liquidity for large, universal banks to finance trading and speculative investment positions. Turmoil in the multi-trillion dollar repo markets amounts to one massive and non-transparent uncertainty.

All most investors know, for sure, is that dysfunctional repo markets were at the centre of the GFC and the Lehman bankruptcy; along with isolated financial scandals such as Refco & MF Global. After the 2010's "Decade of Debt," today's repo markets are larger and more global; including China and offshore financial centres (e.g. Cayman, Luxembourg, Singapore etc.).

The Fed is reported to have now funnelled $500 billion into the repo market, to control repo rates and the availability of repo liquidity. The Fed's support, in the form of daily and longer-term repo loans, and outright purchases of Treasury bills, does not seem outsized in size or scope, in the context of the broader GCB monetary stimulus of the past decade.

What does seem significant, to us, is the rapid response by the Fed, coupled with reports that the Fed is considering lending directly to smaller "financial institutions" and hedge funds.

We view the following as the significant takeaways from this latest liquidity incident:

- the universal banks that control, and own the GCBs have effectively bypassed the need for Government approvals of financial bailouts,
- as is typical, US legislation such as the "Dodd-Frank Wall Street Reform and Consumer Protection Act" was also drafted, and amended to expand the Fed's autonomy, and scope of monetary policy implementation, and,
- the past decade has been a favourable environment for bank lobbyists to utilize political clout to systematically amend other regulatory impediments to full GCB autonomy.

* All figures quoted are gross of fees in USD.

Is a fully independent GCB system a net positive, or net negative, at this point, in this monetary cycle?

Our Conclusion: a net positive, given we see no possible unwinding of the great monetary experiment that defined the Decade of Debt. The good news? This evolution of a GCB system with full autonomy of unilateral action should render future analysis of that system an exercise in redundancy, to which neither the writers, nor readers of our future high yield commentaries need be subjected.

Fortunately, the macro backdrop of an ever expanding global money supply plays no meaningful role in the disciplined implementation of our investment process. Fortunately, because investment strategies that rely on top-down predictions of the next economic recession, and/or credit crunch have been brutal reminders that "being early is a lot like being wrong."

"Swan Song" GCB Summary: In our opinion, global financial markets have remained resilient at relatively lofty levels due to the actions and statements of the GCBs. Our long-held view has been that the massive monetary stimulus of the past decade cannot be reversed; only accelerated. GCBs will not voluntarily stop "Quantitative Easing" (encompassing financial asset purchases, negative interest rates etc.) until, 1) The GCBs, themselves decide to reset the global fiat currency system, and clear the decks, so to speak, (Gold, anyone?), or 2) The GCB system loses control of interest rates, inflation, and by definition, the global economy. Given those alternative options, the current status quo qualifies as the solid ground.

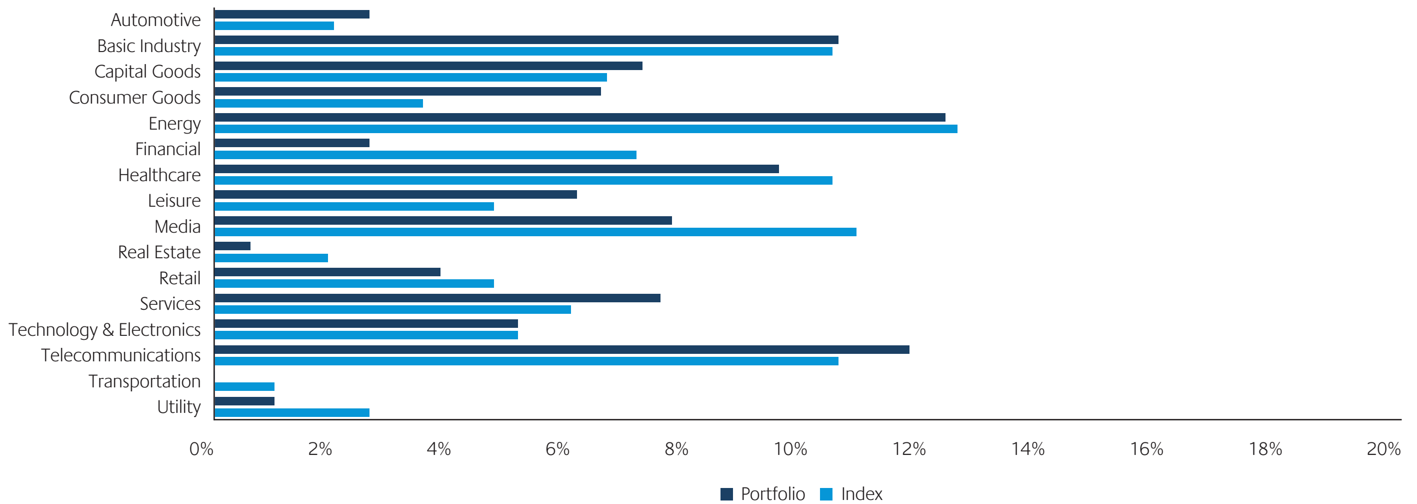
# Broad High Yield

## Characteristics

| | Broad | Index* |
|---|---|---|
| Yield-to-worst | 5.01% | 5.41% |
| Spread-to-worst (3yr Discount Margin) | 335 | 372 |
| Duration to Worst (avg. 3 year) | 2.93 | 3.00 |
| # of Issuers | 151 | |
| AUM | 151 | |
| Avg. Rating | B1/BB- | |

* Index as of quarter end rebalance

## Sector weightings: Portfolio, Benchmark




## Breakdown by Rating

| | Portfolio |
|---|---|
| BBB- | 2.4 |
| BB+ | 5.0 |
| BB | 16.8 |
| BB- | 23.0 |
| B+ | 17.6 |
| B | 16.8 |
| B- | 7.6 |
| CCC+ | 2.6 |
| CCC | 1.6 |
| CCC- | 0.0 |
| Other* | 1.4 |

* CC, C, D & NR

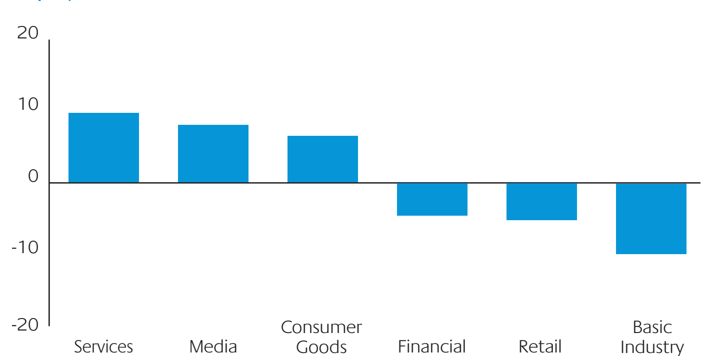
## Breakdown by Country

| | Risk Contribution % |
|---|---|
| United States | 89.9 |
| Canada | 4.3 |
| Greece | 1.6 |
| Australia | 1.5 |
| United Kingdom | 1.0 |
| Luxembourg | 0.7 |
| France | 0.5 |
| Italy | 0.3 |
| Brazil | 0.1 |

## Top 10 Issuers

| | Portfolio |
|---|---|
| Sprint | 2.4 |
| US Cellular | 2.0 |
| Bausch Health | 1.9 |
| Horizon Therapeutics | 1.8 |
| Asurion | 1.7 |
| Geo Group | 1.6 |
| Icahn Enterprises | 1.5 |
| Telesat | 1.5 |
| NuFarm | 1.5 |
| Reynolds Group | 1.4 |

## Top 3/Bottom 3 Contribution to Excess Return




* The Broad High Yield strategy is a hypothetical portfolio. The assets of the Select High Yield strategy and the Quality High Yield strategy have been combined to create the characteristics of the Broad High Yield strategy.

# Broad High Yield Sector & Issuer

## Positive Contributors (top three):

**GEO Group (GEO):** “GEO”(a real estate investment trust “REIT” that manages secure institutions, ICE processing centres, and community reentry facilities around the globe), reported solid Q319 earnings, and modestly increased forward guidance for full year, 2019. Compared to the previous year, fiscal 2019 revenues, adj. EBITDA* and adj. funds from operations are now projected to increase 7%, 9% and 10%, respectively. The company generates predictable and substantial discretionary free cash flow, maintains strong liquidity and has modest debt maturities before 2024.

**Laredo Petroleum (LPI):** Laredo Petroleum outperformed after reporting strong Q319 results that beat expectations and guiding Free Cash Flow (FCF) generation going forward. Further, the company announced two small bolt-on acquisitions, one in Howard County and the second around Laredo’s existing footprint. The expansions addressed investor concern regarding inventory runway (2+ years of tier 1 well locations added), and are set to accelerate the company’s oil cut as a percentage of production from low 30% to greater than 40% which was taken positively by credit investors as the inventory and high gas production have been investor overhangs on the name historically.

**Vista Outdoor (VSTO):** Vista Outdoor outperformed during the quarter as the earnings story seemed to stabilize, and investors put more weight in the company’s asset value. VSTO is progressing on their margin improvement plan and should continue to improve if/when tariffs roll off as part of any US/China trade deal. Leverage remains high in the business, however we believe that the asset value in the remaining businesses well covers the debt, and the possible catalyst of a deleveraging asset sale continues to make these bonds attractive.

## Negative Contributors (bottom three):

**GrubHub (GRUB):** GrubHub bonds sold-off after reporting disappointing Q319 results. Competitive dynamics deteriorated sharply during the 3rd quarter, with competition no longer simply moderating GrubHub’s strong top-line growth, but rather starting to erode the company’s existing customer base. As a result, the company decided to pursue a change in strategy, namely an aggressive growth plan that will significantly pressure near-term EBITDA and FCF. Our comfort with the credit stemmed from its profitable, measured approach to growth and we no longer felt comfortable underwriting the risk once the company decided to pursue the strategy of its irrational peers. Industry consolidation could help drive improved competitive dynamics, but M&A may not benefit GrubHub bondholders given its competitors’ weak balance sheets and weak Change of Control language in GrubHub bonds.

**California Resources (CRC):** California Resources underperformed after the state of California announced that it would block new fracking and steam-injected oil well drilling permits pending a scientific review against the dangers of these activities on local populace. This represents a stark 180 from Governor Newsom’s previously stated position that he would not (and did not have the power to) outright ban fracking/steam injection. While California Resources stated that they do not use well completions linked to the moratorium, a crux of California Resources’ deleveraging story is a sale of an overriding royalty interest in its current acreage, and this moratorium will likely make such a sale less attractive to buyers and delay needed debt retirement going forward. We sold our position in California Resources following the announcement as we view further regulatory escalation as likely, creating a disproportional amount of tail default risk.

**Intelsat (INTEL):** Intelsat underperformed during the fourth quarter after the FCC changed course and decided to hold a public auction for C-Band spectrum, as opposed to letting the satellite companies of the C-Band Alliance (CBA) perform a private auction. The market was anticipating a private auction by the CBA which would have resulted in higher proceeds, but after public pushback from Louisiana Senator John Kennedy, the FCC proceeded with a public auction. Additionally, prominent members of Congress have pushed for at least 50% of proceeds to be given to the US Treasury for rural infrastructure buildout, further reducing proceeds to Intelsat. We believe the move down in bonds was overdone and remain optimistic that despite an FCC run auction and pushback from Congress on allocation of proceeds, Intelsat will be appropriately compensated for relinquishing their spectrum.

* Earnings before interest, tax, depreciation and amortization

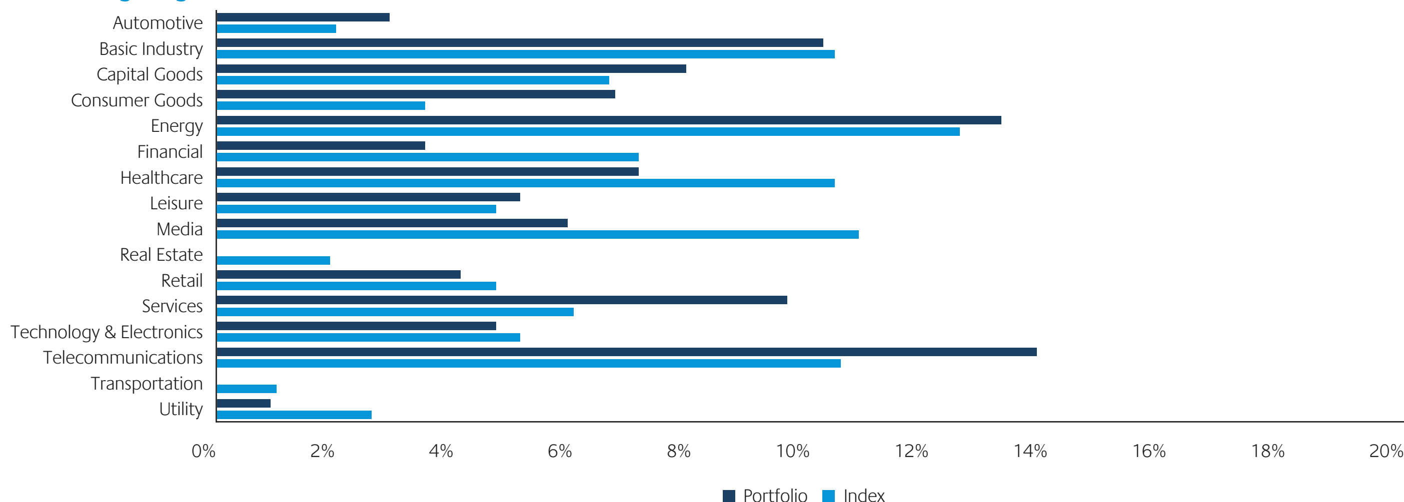
# Select High Yield

## Characteristics

| | Select | Index* |
|---|---|---|
| Yield-to-worst | 5.45% | 5.41% |
| Spread-to-worst (3yr Discount Margin) | 379 | 372 |
| Duration to Worst (avg. 3 year) | 2.96 | 3.00 |
| # of Issuers | 123 | |
| AUM | 65 | |
| Avg. Rating | B1/B+ | |

*Index as of quarter end rebalance

## Sector weightings: Portfolio, Benchmark




## Breakdown by Rating

| | Portfolio |
|---|---|
| BBB- | 1.7 |
| BB+ | 3.7 |
| BB | 12.9 |
| BB- | 21.5 |
| B+ | 16.6 |
| B | 18.2 |
| B- | 10.0 |
| CCC+ | 6.1 |
| CCC | 3.6 |
| CCC- | 0.0 |
| Other* | 1.4 |

* CC, C, D & NR

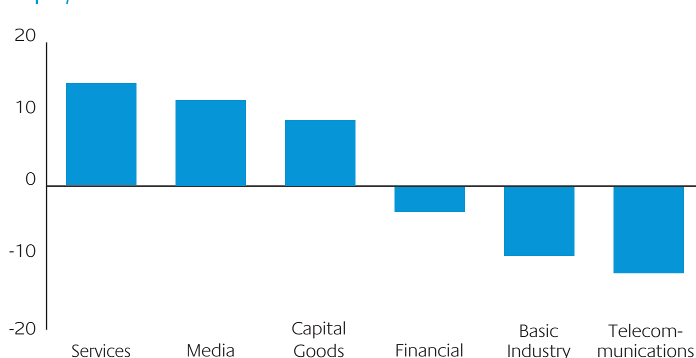
## Breakdown by Country

| | Risk Contribution % |
|---|---|
| United States | 89.8 |
| Canada | 3.6 |
| Greece | 1.8 |
| Australia | 1.4 |
| Luxembourg | 1.4 |
| United Kingdom | 1.0 |
| France | 0.4 |
| Italy | 0.4 |
| Brazil | 0.1 |

## Top 10 Issuers

| | Market Value % |
|---|---|
| Sprint | 2.8 |
| Geo Group | 2.1 |
| Iridium | 2.1 |
| Asurion | 1.9 |
| Assured Partners | 1.9 |
| Bausch Health | 1.9 |
| Centurylink | 1.8 |
| US Cellular | 1.8 |
| NuFarm | 1.7 |
| Horizon Therapeutics | 1.7 |

## Top 3/Bottom 3 Contribution to Excess Return



# Select High Yield Sector & Issuer

## Positive Contributors (top three):

**GEO Group (GEO):** "GEO" (a real estate investment trust "REIT" that manages secure institutions, ICE processing centres, and community reentry facilities around the globe), reported solid Q319 earnings, and modestly increased forward guidance for full year, 2019. Compared to the previous year, fiscal 2019 revenues, adj. EBITDA and adj. funds from operations are now projected to increase 7%, 9% and 10%, respectively. The company generates predictable and substantial discretionary free cash flow, maintains strong liquidity and has modest debt maturities before 2024.

**Laredo Petroleum (LPI):** Laredo Petroleum outperformed after reporting strong Q319 results that beat expectations and guiding FCF generation going forward. Further, the company announced two small bolt-on acquisitions, one in Howard County and the second around Laredo's existing footprint. The expansions addressed investor concern regarding inventory runway (2+ years of tier 1 well locations added), and are set to accelerate the company's oil cut as a percentage of production from low 30% to greater than 40% which was taken positively by credit investors as the inventory and high gas production have been investor overhangs on the name historically.

**Icahn Enterprises (IEP):** Icahn Enterprises Holdings L.P. (95% owned by Carl Icahn), owns interests in subsidiary companies with both private and public company investments. Public market investments are currently valued well in in excess of 2x net holding company debt; other private subsidiary investments (primarily Icahn Automotive) provide additional, substantial asset coverage. Investment fund performance was weak in Q319, primarily due to a net short positioning; however, not a meaningfully negative for its public bonds. Current capital markets have been providing the opportunity to call, and refinance near-term, higher coupon debt.

## Negative Contributors (bottom three):

**Intelsat (INTEL):** Intelsat underperformed during the fourth quarter after the FCC changed course and decided to hold a public auction for C-Band spectrum, as opposed to letting the satellite companies of the C-Band Alliance (CBA) perform a private auction. The market was anticipating a private auction by the CBA which would have resulted in higher proceeds, but after public pushback from Louisiana Senator John Kennedy, the FCC proceeded with a public auction. Additionally, prominent members of Congress have pushed for at least 50% of proceeds to be given to the US Treasury for rural infrastructure buildout, further reducing proceeds to Intelsat. We believe the move down in bonds was overdone and remain optimistic that despite an FCC run auction and pushback from Congress on allocation of proceeds, Intelsat will be appropriately compensated for relinquishing their spectrum.

**GrubHub (GRUB):** GrubHub bonds sold-off after reporting disappointing Q319 results. Competitive dynamics deteriorated sharply during the 3rd quarter, with competition no longer simply moderating GrubHub's strong top-line growth, but rather starting to erode the company's existing customer base. As a result, the company decided to pursue a change in strategy, namely an aggressive growth plan that will significantly pressure near-term EBITDA and FCF. Our comfort with the credit stemmed from its profitable, measured approach to growth and we no longer felt comfortable underwriting the risk once the company decided to pursue the strategy of its irrational peers. Industry consolidation could help drive improved competitive dynamics, but M&A may not benefit GrubHub bondholders given its competitors' weak balance sheets and weak Change of Control language in GrubHub bonds.

**California Resources (CRC):** California Resources underperformed after the state of California announced that it would block new fracking and steam-injected oil well drilling permits pending a scientific review against the dangers of these activities on local populace. This represents a stark 180 from Governor Newsom's previously stated position that he would not (and did not have the power to) outright ban fracking/steam injection. While California Resources stated that they do not use well completions linked to the moratorium, a crux of California Resources' deleveraging story is a sale of an overriding royalty interest in its current acreage, and this moratorium will likely make such a sale less attractive to buyers and delay needed debt retirement going forward. We sold our position in California Resources following the announcement as we view further regulatory escalation as likely, creating a disproportional amount of tail default risk.

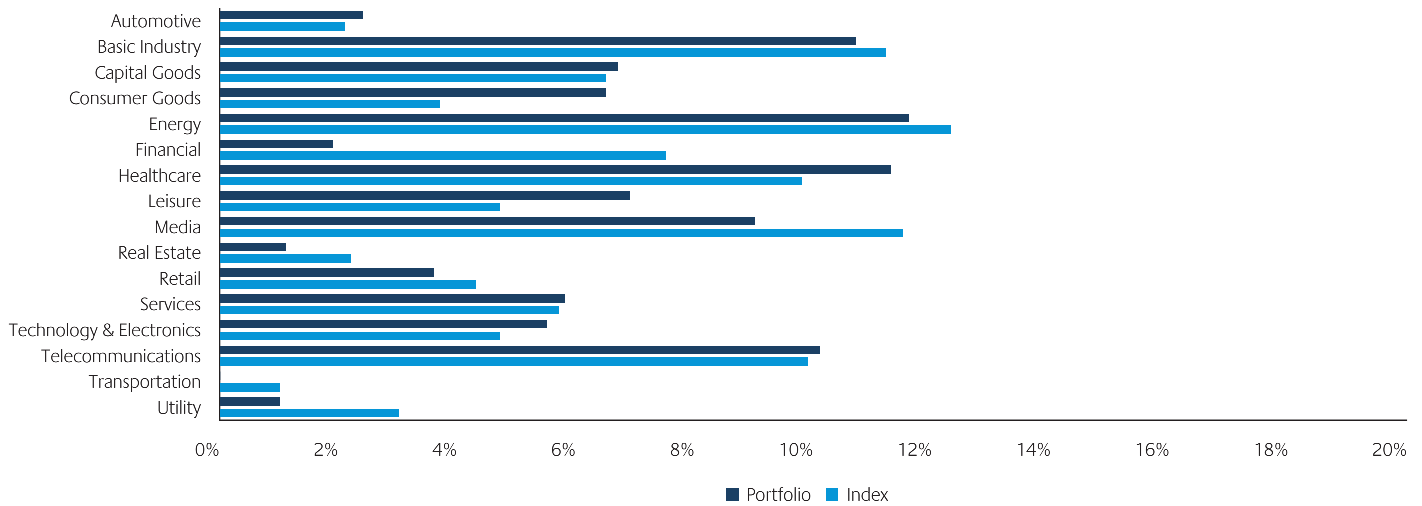
# Quality High Yield

## Characteristics

| | Quality | Index* |
|---|---|---|
| Yield-to-worst | 4.67% | 4.53% |
| Spread-to-worst (3yr Discount Margin) | 301 | 283 |
| Duration to Worst (avg. 3 year) | 2.92 | 3.03 |
| # of Issuers | 146 | |
| AUM | 86 | |
| Avg. Rating | B1/BB- | |

* Index as of quarter end rebalance

## Sector weightings: Portfolio, Benchmark




## Breakdown by Rating

| | Portfolio |
|---|---|
| BBB- | 3.0 |
| BB+ | 5.9 |
| BB | 19.8 |
| BB- | 24.1 |
| B+ | 18.4 |
| B | 15.8 |
| B- | 5.7 |
| CCC+ | 0.0 |
| CCC | 0.0 |
| Other* | 1.3 |

* NR & NA

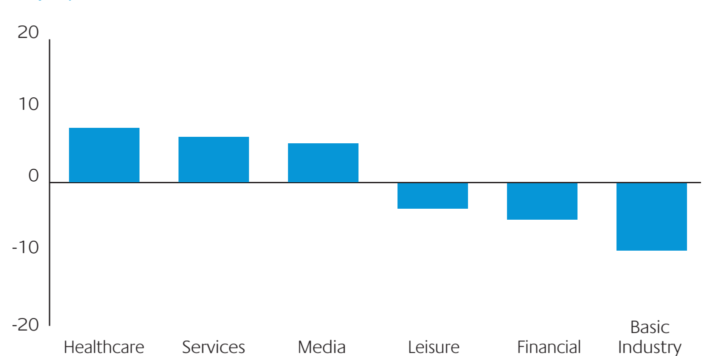
## Breakdown by Country

| | Risk Contribution % |
|---|---|
| United States | 89.7 |
| Canada | 5.2 |
| Australia | 1.6 |
| Greece | 1.4 |
| United Kingdom | 1.1 |
| France | 0.7 |
| Italy | 0.3 |
| Brazil | 0.1 |

## Top 10 Issuers

| | Market Value % |
|---|---|
| US Cellular | 2.2 |
| Sprint | 2.1 |
| Bausch Health | 1.9 |
| Horizon Therapeutics | 1.9 |
| Charter Communications | 1.7 |
| Telesat | 1.6 |
| Icahn Enterprises | 1.5 |
| CSC Holdings | 1.5 |
| Asurion | 1.5 |
| Sirius XM Radio | 1.4 |

## Top 3/Bottom 3 Contribution to Excess Return



# Quality High Yield Sector & Issuer

## Positive Contributors (top three):

**Horizon Pharma (HZNP):** HZNP's strong performance over the quarter was mainly led by the FDA Advisory Committee's unanimous support for its Thyroid Eye Disease (TED) drug Teprotumumab. Tepro, which is the second big drug in the company's orphan and rheumatology portfolio, could see peak sales of >$700mn (per company's projections) resulting in >50% top-line growth. With a conservatively leveraged balance sheet, strong cash flow generation and no imminent litigation risk, HZNP continues to perform well among pharmaceutical peers.

**GEO Group (GEO):** "GEO" (a real estate investment trust "REIT" that manages secure institutions, ICE processing centres, and community reentry facilities around the globe), reported solid Q319 earnings, and modestly increased forward guidance for full year, 2019. Compared to the previous year, fiscal 2019 revenues, adj. EBITDA and adj. funds from operations are now projected to increase 7%, 9% and 10%, respectively. The company generates predictable and substantial discretionary free cash flow, maintains strong liquidity and has modest debt maturities before 2024.

**Icahn Enterprises (IEP):** Icahn Enterprises Holdings L.P. (95% owned by Carl Icahn), owns interests in subsidiary companies with both private and public company investments. Public market investments are currently valued well in in excess of 2x net holding company debt; other private subsidiary investments (primarily Icahn Automotive) provide additional, substantial asset coverage. Investment fund performance was weak in Q319, primarily due to a net short positioning; however, not a meaningfully negative for its public bonds. Current capital markets have been providing the opportunity to call, and refinance near-term, higher coupon debt.

## Negative Contributors (bottom three):

**GrubHub (GRUB):** GrubHub bonds sold-off after reporting disappointing Q319 results. Competitive dynamics deteriorated sharply during the 3rd quarter, with competition no longer simply moderating GrubHub's strong top-line growth, but rather starting to erode the company's existing customer base. As a result, the company decided to pursue a change in strategy, namely an aggressive growth plan that will significantly pressure near-term EBITDA and FCF. Our comfort with the credit stemmed from its profitable, measured approach to growth and we no longer felt comfortable underwriting the risk once the company decided to pursue the strategy of its irrational peers. Industry consolidation could help drive improved competitive dynamics, but M&A may not benefit GrubHub bondholders given its competitors' weak balance sheets and weak Change of Control language in GrubHub bonds.

**California Resources (CRC):** California Resources underperformed after the state of California announced that it would block new fracking and steam-injected oil well drilling permits pending a scientific review against the dangers of these activities on local populace. This represents a stark 180 from Governor Newsom's previously stated position that he would not (and did not have the power to) outright ban fracking/steam injection. While California Resources stated that they do not use well completions linked to the moratorium, a crux of California Resources' deleveraging story is a sale of an overriding royalty interest in its current acreage, and this moratorium will likely make such a sale less attractive to buyers and delay needed debt retirement going forward. We sold our position in California Resources following the announcement as we view further regulatory escalation as likely, creating a disproportional amount of tail default risk.

**ORBCOMM (ORBC):** Orbcomm underperformed in the fourth quarter following mixed Q4 results and 2020 guidance as a result of the slowdown in the North America transport market, namely industrial trucking. As a provider of satellite IoT solutions for transport containers, Orbcomm saw orders slow as companies pushed-out their container orders following large declines in volume. The Orbcomm bond is a small, illiquid issue with only one market-maker who was a seller which led to it getting marked down. Fundamentals remain intact and Orbcomm still expects revenue and EBITDA growth through 2020 from new order wins in other end markets including maritime shipping, heavy equipment, and government.

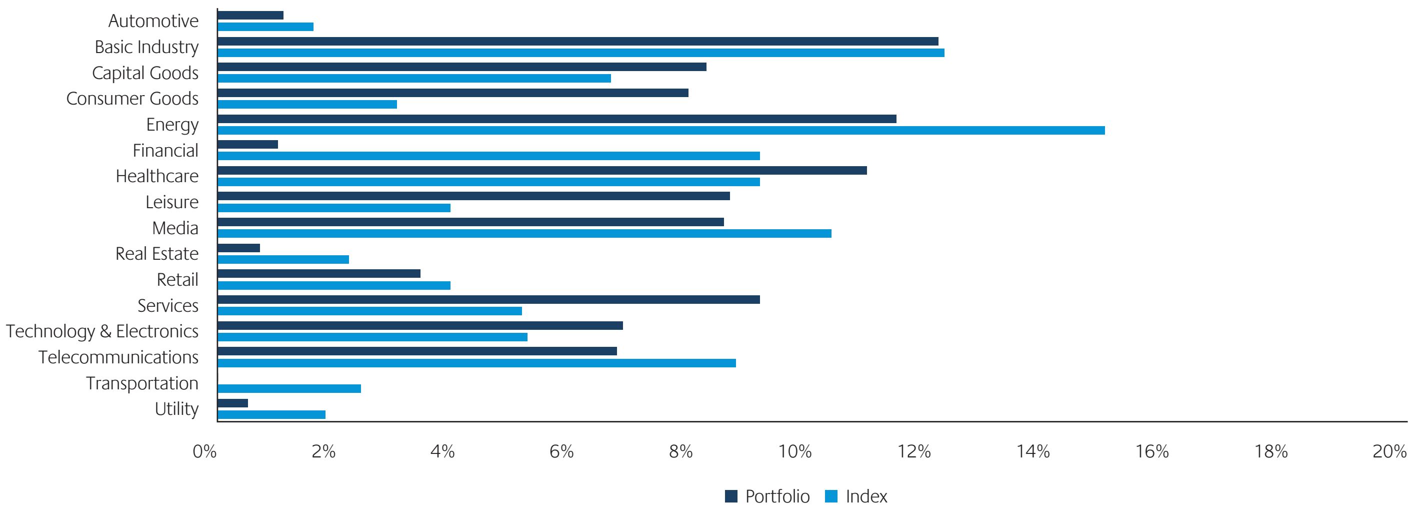
# Short Duration High Yield

## Characteristics

| | Short Duration | Index* |
|---|---|---|
| Yield-to-worst | 4.01% | 4.35% |
| Spread-to-worst (3yr Discount Margin) | 242 | 267 |
| Duration to Worst (avg. 3 year) | 1.26 | 1.76 |
| # of Issuers | 102 | |
| AUM | 36 | |
| Avg. Rating | B1/BB- | |

*Index as of quarter end rebalance

## Sector weightings: Portfolio, Benchmark




## Breakdown by Rating

| | Portfolio |
|---|---|
| BBB- | 3.3 |
| BB+ | 2.6 |
| BB | 19.8 |
| BB- | 22.0 |
| B+ | 21.8 |
| B | 19.6 |
| B- | 6.4 |
| CCC+ | 0.0 |
| CCC | 0.0 |
| Other* | 1.3 |

*NR & NA

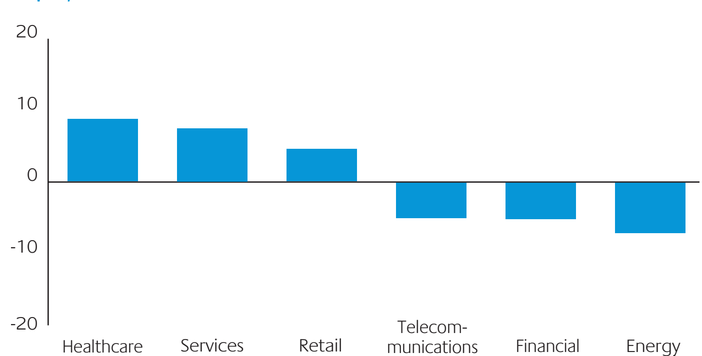
## Breakdown by Country

| | Risk Contribution % |
|---|---|
| United States | 97.4 |
| Canada | 1.9 |
| France | 0.5 |
| Brazil | 0.2 |

## Top 10 Issuers

| | Market Value % |
|---|---|
| Bausch Health | 2.5 |
| Reynolds Group | 2.5 |
| Stars Group | 2.3 |
| Sprint | 2.2 |
| Dell | 2.1 |
| TransDigm | 1.9 |
| Asurion | 1.8 |
| Albertsons | 1.6 |
| Refinitiv | 1.6 |
| Nielsen Holdings | 1.6 |

## Top 3/Bottom 3 Contribution to Excess Return



# Short Duration Sector & Issuer

## Positive Contributors (top three):

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**Bausch Health (BHCCN):** Bausch health reported another quarter of strong results that beat street estimates for revenue and EBITDA in November. In addition to these strong results, the company reported that it has resolved the 2015 US securities class action suit related to the sharp drop in the then Valeant's stock price. The debt-funded c. $1.2bn settlement, while large and leveraging, resolved one of the largest unknown litigation liabilities faced by BHCCN (it remains free of the opioid and generic drug pricing litigations faced by most pharmaceutical peers). The company issued $2.5bn of new notes, using half of the proceeds to fund the settlement and the remainder to partially redeem 2023 notes.

**Laredo Petroleum (LPI):** Laredo Petroleum outperformed after reporting strong Q319 results that beat expectations and guiding FCF generation going forward. Further, the company announced two small bolt-on acquisitions, one in Howard County and the second around Laredo's existing footprint. The expansions addressed investor concern regarding inventory runway (2+ years of tier 1 well locations added), and are set to accelerate the company's oil cut as a percentage of production from low 30% to greater than 40% which was taken positively by credit investors as the inventory and high gas production have been investor overhangs on the name historically.

## Negative Contributors (bottom three):

**California Resources (CRC):** California Resources underperformed after the state of California announced that it would block new fracking and steam-injected oil well drilling permits pending a scientific review against the dangers of these activities on local populace. This represents a stark 180 from Governor Newsom's previously stated position that he would not (and did not have the power to) outright ban fracking/steam injection. While California Resources stated that they do not use well completions linked to the moratorium, a crux of California Resources' deleveraging story is a sale of an overriding royalty interest in its current acreage, and this moratorium will likely make such a sale less attractive to buyers and delay needed debt retirement going forward. We sold our position in California Resources following the announcement as we view further regulatory escalation as likely, creating a disproportional amount of tail default risk.

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**Oasis Petroleum (OAS):** Oasis Petroleum underperformed after investor concerns arose that Bakken crude and natural gas differentials would drag on Q319 hydrocarbon price realizations as offtake capacity remained challenged in the basin, especially on the gas side. This came following results from Northern Oil and Gas (which has a meaningful portion of its minority working interests in Oasis wells) reporting weak realizations and delays/well shut-ins during Q319 related to heavy rain forcing production halts. We sold Oasis bonds ahead of earnings on this news to remove the risk related to the basin exposure, which we saw as downside skewed.

# Co-Portfolio Managers: High Yield

**Jason Epstein**
Senior Portfolio Manager
Co-Head of High Yield

Jason joined First State Investments in September 2016. He has 18 years of industry experience.

He was a Managing Director with Oak Hill Advisors where he was responsible for managing a team of analysts covering a broad range of sectors.

Prior to Oak Hill, Jason was an analyst within investment banking at Credit Suisse First Boston where he was a member of both the Financial Sponsors and Technology groups.

Jason has a BS in Economics from The Wharton School, University of Pennsylvania.

**Matt Philo, CFA**
Senior Portfolio Manager,
Co-Head of High Yield

Matt joined First State Investments in May 2016. He has 30 years of industry experience.

He was Executive Managing Director & Head of High Yield at MacKay Shields LLC.

He managed the Mainstay High Yield Corporate Bond Fund (MYHIX) from December 2000 through May 2014.

Matt has an MBA in finance from New York University and a BA from University at Albany SUNY. Matt is a CFA Charterholder.

For further institutional enquiries contact institutionalenquiries@firststate.co.uk

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