For professional clients only

First State Investments

Quarterly Update | High Yield

First State Investments High Yield

Q2 2019 | Co-Portfolio Managers: Matt Philo & Jason Epstein

"Success breeds complacency. Complacency breeds failure. Only the paranoid survive." *– Andy Grove*

Thoughts on the Market

Big picture, the U.S. High Yield market, as represented by the ICE BofAML US High Yield Constrained Index (HUC0) posted a solid +2.57% total return during Q2'19, on the heels of Q1'19's strongest quarterly return since 2009; YTD +10.16%. A sharp rally in US Treasury bonds resulted in a +4.23% total return for the 10-Year in Q2'19; +7.45% YTD. As a result, the US Investment Grade market, as represented by the ICE BofAML US Corporate Index (C0A0) outperformed US High Yield during the quarter with an impressive +4.35% total return; lagging US High Yield by just 58 bps YTD. Meanwhile, the S&P 500 equity index added a further +4.3% Q2'19 total return to its very strong Q1'19, posting a +18.54% total return YTD. These financial market results would probably have suggested strong global economic conditions to most investors, despite the curious decline in US Treasury rates…last century!

While we are not the least bit surprised by the "whatever it takes" commitment to monetary stimulus by the Global Central Banks ('GCBs'), we are somewhat disconcerted by the magnitude of the YTD yield declines, to all-time record lows, of the 10-Year Sovereigns, highlighted in yellow:

Region/Country	Sovereign 10-Year Yields (%)					% Chng	Yld Chng
All-Time Low	*2018 High*	*12/31/18*	03/31/19	06/30/19	07/05/19	*YTD June*	*YTD June*
Americas							
Canada	2.60	1.97	1.62	1.46	1.57	-20%	-0.40
United States	3.24	2.69	2.41	2.01	2.04	-24%	-0.65
Mexico (USD)	4.97	4.58	4.03	3.64	3.59	-22%	-0.99
Brazil (USD)	6.34	5.16	5.31	4.77	4.58	-11%	-0.58
EMEA							
Switzerland	0.17	-0.28	-0.41	-0.55	-0.64	-476%	-0.36
Germany	0.77	0.24	-0.07	**-0.33**	-0.37	-148%	-0.60
Netherlands	0.80	0.38	0.03	**-0.16**	-0.22	-127%	-0.60
France	1.02	**0.71**	0.32	**-0.01**	-0.09	**-109%**	**-0.79**
Sweden	0.98	0.46	0.31	0.02	-0.01	-101%	-0.47
Spain	1.73	**1.41**	1.09	**0.39**	0.32	**-77%**	**-1.09**
United Kingdom	1.73	1.28	1.00	0.83	0.73	-42%	-0.54
Italy	3.68	2.74	2.49	2.10	1.74	-36%	-1.00
Greece	4.74	**4.35**	3.73	**2.43**	2.12	**-51%**	**-2.22**
Poland	3.56	2.81	2.83	2.38	2.28	-19%	-0.54
Russia	9.22	8.70	8.38	7.42	7.36	-15%	-1.34
Asia/Pacific							
Japan	0.16	-0.01	-0.09	-0.16	-0.17	-209%	-0.17
Australia	2.94	2.32	1.78	1.33	1.28	-45%	-1.04
Hong Kong	2.50	1.95	1.40	1.46	1.42	-27%	-0.53
China	3.97	3.30	3.06	3.23	3.17	-4%	-0.13

Source: Bloomberg

"Disconcerted" is a high bar to those old enough to have invested during the collapse of Japanese stocks in 1990, the 1997-1998 Asian crisis and Russian default, the bursting of the TMT* bubble in 2000, and the GFC of 2007-2008. However, as just one example, we find nothing "normal" about a Spanish 10-Year yielding 40 bps, annually. Please see: Analysis: "Curiouser and curiouser!" on **page 5.**

Q2 2019:

The nearly all-inclusive "everything rally" of Q1'19 continued over the course of Q2'19, for the same overriding reason: Global Central Bank actions and statements. While the disciplined implementation of our high yield investment process is largely unaffected by monetary insanity, the following is a brief summary of the synchronous, dovish words and actions of the GCB's:

In early January, **Fed** Chair Jerome Powell performed a monetary U-turn by indicating the Fed would be flexible on policy and was in no hurry to raise interest rates. At the June FOMC meeting, the central bank talked of increased "uncertainties" about the economic outlook, and Powell subsequently repeated his comment "an ounce of prevention is worth more than a pound of cure." The markets are now pricing in three rate cuts in total this year, with a further 25bp cut in early 2020.

The **ECB** said its main refinancing rate is now expected to remain at 0% through the first half of 2020. In June, outgoing ECB President Mario Draghi said the ECB could cut interest rates again or conduct more asset purchases if inflation doesn't meet its target.

Each month, **BOJ** Governor Haruhiko Kuroda's press briefing outlines measures he claims could be utilized to help the quest for target inflation, a quest that doesn't go anywhere.

The **People's Bank of China** is now not only considering cutting the reserve requirement ratio (RRR) to provide liquidity, but also cutting interest rates, as the economy needs more fiscal stimulus.

Finally, "Down Under" the **Reserve Bank of Australia** cut rates for the second consecutive month in July, taking the cash rate target to 1.0%.

We find it "interesting" that GCBs have been the clear drivers of this year's strong financial market rallies, but are now faced with the prospect of fulfilling pledges to ease monetary policy with major U.S. stocks indexes, and EU sovereign bond markets at all-time highs. Seemingly a classic example of, "caught between a rock and a hard place."

Exhibit 1: Returns of Various Assets

Asset Class	1H'19	2Q'19	Jun'19	May'19	Apr'19	1Q'19	CY2018	4Q'18
S&P 500	**18.54%**	4.30%	7.05%	-6.35%	4.05%	**13.65%**	-4.39%	**-13.52%**
Emerging Market Stocks	11.06%	*0.69%*	**6.28%**	-7.23%	2.12%	**10.30%**	**-14.28%**	**-7.38%**
10-Year US Treasury	**7.45%**	**4.23%**	**1.44%**	**3.35%**	-0.59%	**3.10%**	-0.03%	**3.86%**
Investment Grade Corp	9.57%	**4.35%**	2.30%	1.44%	0.57%	5.01%	-2.25%	*-0.06%*
US High Yield Corp Bonds	**10.16%**	2.57%	2.45%	-1.27%	1.40%	**7.40%**	-2.27%	-4.67%
Leveraged Loans	5.58%	1.63%	**0.28%**	-0.24%	1.59%	3.89%	1.08%	-3.16%
Euro High Yield Corps	7.73%	2.33%	2.48%	-1.50%	1.37%	5.28%	-3.63%	-3.59%
EM High Yield Corps	9.25%	3.08%	2.49%	-0.15%	0.72%	5.98%	-2.29%	*-0.14%*
US High Yield by Rating								
BB US High Yield Corps	**10.77%**	**3.17%**	2.81%	-0.73%	1.09%	7.36%	-2.57%	-3.05%
B US High Yield Corps	9.83%	2.31%	2.36%	-1.58%	1.55%	7.35%	-1.72%	-4.91%
CCC US High Yield Corps	*8.51%*	*0.58%*	*1.25%*	**-2.76%**	**2.16%**	7.89%	**-4.91%**	**-10.32%**

Source: JP Morgan, ICE BAML

Discrete Annual Performance Summary

Period	12 mths to 30/06/19	12 mths to 30/06/18	12 mths to 30/06/17	12 mths to 30/06/16	12 mths to 30/06/15
S&P 500	10.42%	14.37%	17.90%	3.99%	7.42%
Emerging Market Stocks	1.21%	8.20%	23.74%	-12.05%	-5.13%
10-Year US Treasury	10.38%	-2.69%	-5.58%	9.49%	3.79%
Investment Grade Corp	10.56%	-0.70%	2.33%	7.38%	1.01%
US High Yield Corp Bonds	7.58%	2.53%	12.75%	1.71%	-0.55%
Leverage Loans	4.30%	4.74%	7.18%	1.82%	2.66%
Euro High Yield Corps	5.60%	0.83%	9.65%	2.45%	1.91%
EM High Yield Corps	10.66%	-0.08%	11.10%	6.65%	-2.94%
BB US High Yield Corps	9.88%	0.66%	9.90%	4.33%	1.67%
B US High Yield Corps	6.85%	3.49%	12.60%	-0.23%	-0.37%
CCC US High Yield Corps	0.03%	6.81%	22.09%	-0.73%	-7.03%

Source: MSCI, JP Morgan, ICE BAML

Notable within Q2'19 was pronounced weakness in global equity, and high yield credit markets during May. Market pundits were fixated on U.S. trade negotiations with China, in particular, as a primary cause of the May sell-off. We don't pretend to know all the reasons, if any of most overall market moves, but we think institutional investors became generally concerned about global economic growth prospects. According to FactSet, S&P 500 Q2'19 consensus earnings estimates forecasted a -0.5% decline on March 31, and -2.6% as of July 3rd with 88 S&P 500 companies have issuing negative guidance, versus positive guidance from 26 companies. In general, recent economic reports regarding global manufacturing activity and global trade volumes weakened during the quarter.

Q2'19 earnings reports begin mid-July and that is how we form our most accurate views on U.S. and global growth prospects; having grown accustomed to reading through today's "pro forma, adjusted' and "non-GAAP" reporting norms.

Other market trends during the quarter largely reflected the sharp decline in Treasury rates. U.S. High Yield outperformed U.S. High Grade during Q1'19 despite a noticeable rally in Treasury rates; and the High Yield market index's duration nearly 4 years shorter than that of the High Grade index. High Yield was unable to repeat that accomplishment in 2Q'19 as the U.S. Treasury rally was sharper, and the percentage of the High Yield index trading to a call date increased from just 8% at the start of Q1'19, to 31% at the end of Q2'19.

Going forward, we much prefer the 2.6% current income advantage of High Yield, versus High Grade corporates; as compared to the greater interest rate sensitivity of High Grade (with 7.3 years duration, versus just 3.4 years for High Yield).**

High Yield Market Commentary

The U.S. HY market, as represented by the ICE BofAML US High Yield Constrained Index (HUC0) produced a solid +2.57% total return during Q2'19. June was the strongest month during the quarter, as a late-May plunge in US Treasury rates seemed to trigger the sharp rise in equity prices during June. At the end of May, the High Yield index total return for the quarter was barely positive at +11 bps, (-93 bps in price, and +104 bps in income). June's strong +245 bps total return was led by many of the weakest sectors during May: e.g. Metals/Mining and Chemicals. One meaningful exception was the High Yield market's largest sector: Energy. The price of WTI crude peaked during 2Q'19 at $66.06/bbl on Apr-23, bottomed at $51.37 on Jun-12 and ended the quarter at $58.47. At quarter end, Energy was the only industry sector with a Q2'19 negative total return of -0.08%.

*Technology Media and Telecoms

**As measured by ICE Bofaml indexes as of June 30, 2019.

For the overall High Yield market, accounting for the relative weights of industry sectors, the strongest performers were Telecommunications, Cable TV & Non-Food Retail. The weakest performing sectors for the overall market were Energy, Healthcare and Technology.

For the quarter, the CCC-rated tranche of the Index sharply underperformed the single-B and BB tranches. CCC's outperformed in April, were hammered during the May sell-off, and lagged the Treasury rate-led rally in June.

Summary:
The **HUC0 Index** began, and ended Q2'19, as follows:

As of March 31, 2019:
Yield-to-worst of 6.48%, spread-to-worst (STW) of +417 bps, duration-to-worst of 3.7, average price of 97.69

As of June 30, 2019:
Yield-to-worst of 6.06%, spread-to-worst of +421 bps, duration- to-worst of 3.4, average price of 98.91

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 industry sectors making the strongest contributions to portfolio performance were Consumer Goods, Energy and Basic Industry. Consumer Goods' performance was driven by superior security selection in Personal & Household Products *(e.g. see: Vista Outdoors in "Positive Contributors")*, and Food Producers *(e.g. see: JBS USA in "Positive Contributors")*. The outperformance of Energy, in direct contrast to the overall market, was primarily driven by superior security selection in Exploration & Production ("E&P") and Oilfield Services (with a general quality bias in E&P*)*. The positive contribution of Basic Industry was driven by Homebuilders *(e.g. see: Brookfield Residential in "Positive Contributors")*, and Building Materials *(strong credit selection)*.

Conversely, the sectors making the weakest contribution to performance included Financial *(due to our 6.4% underweight relative to the index)*. Media was a modest underperformer *(no exposure to one name in Satellite TV)*, as was Telecommunications *(primarily lagging security selection in Satellite Operators)*.

Our team was relatively active in the portfolios during the quarter as our investment process guided us through meaningful inter-quarter price volatility, on both the upside, and downside. Looking at noticeable trends that emerged from our daily portfolio management:

We reduced our portfolio exposure to Metals during April and we were net sellers of E&P during the quarter. There was no noticeable industry trend to our purchases however we added a relatively high, 9 new credit positions via the new issue market; the majority during the market turmoil from early-May, through early-June.

In general, our largest sector overweight at quarter ended was Consumer Goods, after our investment process led us to reduce Basic Materials; Metals in particular. Our constant sector underweight remains Financials; a sector that may be popular with investors relying on the GCB "put," but one where we find few names that "fit" our investment process.

Our **Broad High Yield** and **Select High Yield** composites posted solid performance relative to their benchmark indexes during the full 2Q'19. Both composites outperformed during April and May, while **Select** outperformed the benchmark's strong June rally by just 3 bps, and **Broad** lagged by just 3 bps.

Our **Quality High Yield** composite modestly outperformed its benchmark index for the full 2Q'19; outperforming in April and May, but giving back more than half that lead over the index benchmark, in June.

Short Duration High Yield and **Defensive High Yield** composites were both ahead of their benchmark indexes at the end of May, but lagged the strong June rally such that both ended the Q2'19, thus lagging their benchmark indexes. We are not surprised when these two composites lag during months of unusually strong performance, and we expect the opposite to be true in months experiencing noticeable benchmark weakness.

In this quarter's topical "Analysis" piece we highlight some potentially worrisome trends in today's "unusual" financial markets. Please see: Analysis: "Curiouser and curiouser!" on **page 5.**

However, we continue to view our High Yield composites as attractive in the absolute, and the best relative value in all of Fixed Income: ► relatively high current income, ► relatively low interest rate sensitivity, and ► default adjusted, yields and spreads that overcompensate for estimated default risk, in each of our high yield composite portfolios. *(See the **Analysis** section in our **Q4'18 commentary** for details regarding our "risk group" methodology).*

As part of our investment process, we estimate the annual default risk of every credit in our portfolios, and require a minimum spread-to-worst that overcompensates for that credit risk. As a result, the weighted average STW of all credits in our portfolios results in a portfolio STW that overcompensates for each portfolio's weighted average, estimated default risk.

In our cumulative High Yield investment experience, we have yet to experience a market environment where our investment process can't identify a fully diversified High Yield portfolio that overcompensates for estimated default risk; the current market posing no exception. Further, we don't fear market volatility or downside corrections; we calmly welcome the opportunities they present. We do not believe this paragraph applies to the majority of our High Yield, peer-group competitors; nor the majority of alternative credit products or asset classes. **"Time will tell."**

Composite Performance Summary

High Yield Composites - Annualized

As of June 30, 2019			Fixed Income Composites - Annualized						Inception April 30, 2017
	Q2'19	June	May	April	Q1'19	YTD'19	12 mths to 30/06/2019	12 mths to 30/06/2018	2018	Since Inception (Annualized)
Broad High Yield	**3.01%**	**2.42%**	**-0.95%**	**1.54%**	**7.49%**	**10.73%**	**8.15%**	**3.58%**	**-1.62%**	**6.00%**
ICE BofAML US HY Const Idx	*2.56%*	*2.45%*	*-1.27%*	*1.40%*	*7.40%*	*10.16%*	*7.58%*	*2.54%*	*-2.27%*	*5.11%*
ActivePerformance	*+0.45%*	*-0.03%*	*+0.32%*	*+0.14%*	*+0.09%*	*+0.57%*	*+0.57%*	*+1.05%*	*+0.65%*	*+0.89%*
Select High Yield	**3.06%**	**2.48%**	**-1.04%**	**1.62%**	**7.86%**	**11.16%**	**7.42%**	**4.16%**	**-2.06%**	**5.96%**
ICE BofAML US HY Const Idx	*2.56%*	*2.45%*	*-1.27%*	*1.40%*	*7.40%*	*10.16%*	*7.58%*	*2.54%*	*-2.27%*	*5.11%*
ActivePerformance	*+0.49%*	*+0.03%*	*+0.24%*	*+0.22%*	*+0.46%*	*+1.00%*	*-0.15%*	*+1.62%*	*+0.21%*	*+0.84%*
Quality High Yield	**2.97%**	**2.36%**	**-0.86%**	**1.47%**	**7.20%**	**10.38%**	**8.43%**	**3.31%**	**-1.34%**	**5.99%**
ICE BofAML BB-B US HY Constr	*2.82%*	*2.59%*	*-1.05%*	*1.28%*	*7.34%*	*10.36%*	*8.62%*	*1.85%*	*-2.04%*	*5.24%*
ActivePerformance	*+0.15%*	*-0.23%*	*+0.19%*	*+0.19%*	*-0.14%*	*+0.02%*	*-0.19%*	*+1.46%*	*+0.71%*	*+0.75%*
Defensive High Yield	**2.48%**	**1.98%**	**-0.73%**	**1.23%**	**6.46%**	**9.10%**	**7.49%**	**3.39%**	**-0.83%**	**5.55%**
ICE BofAML BB-B US HY Constr	*2.82%*	*2.59%*	*-1.05%*	*1.28%*	*7.34%*	*10.36%*	*8.62%*	*1.85%*	*-2.04%*	*5.24%*
ActivePerformance	*-0.33%*	*-0.61%*	*+0.32%*	*-0.05%*	*-0.88%*	*-1.26%*	*-1.13%*	*+1.54%*	*+1.21%*	*+0.30%*
Short Duration High Yield	**1.76%**	**1.43%**	**-0.53%**	**0.87%**	**5.22%**	**7.07%**	**6.22%**	**3.47%**	**0.53%**	**4.78%**
ICE BAM 1-5 Y BB-B US Cs Py HY	*1.88%*	*1.69%*	*-0.69%*	*0.88%*	*5.49%*	*7.47%*	*6.82%*	*3.08%*	*0.67%*	*4.94%*
ActivePerformance	*-0.12%*	*-0.26%*	*+0.16%*	*-0.02%*	*-0.27%*	*-0.40%*	*-0.61%*	*+0.38%*	*-0.15%*	*-0.17%*

Past performance is not indicative of future performance. Performance figures do not reflect the deduction of investment advisory fees. A client's return will be reduced by the investment fees. If a client placed $100,000 under management and a hypothetical gross return of 10% were achieved, the investment assets before fees would have grown to $259,374 in 10 years. However, if an advisory fee of 1% were charged, investment assets would have grown to $234,573, or an annual compounded rate of 8.9%.

The assets within the FSI Short Duration High Yield Composite and FSI Quality High Yield Composite have been combined to create the FSI Defensive High Yield Composite. 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.

Due to rounding percentages may not precisely reflect absolute figures.

Analysis: "Curiouser and curiouser!" - *Alice in Wonderland*

Last quarter, we pointed out that the investment management industry is predictable, if nothing else. Investment managers never let a bull-market go to waste in pursuit of higher fees via financial engineering. This financial market, super-cycle has also produced a seemingly massive pool of investors and plan sponsors that are some combination of desperate for income, *(congrats GCBs)* or, complacent in the assumption that traditional bear markets are a thing of the past; somewhat understandable after 20 years of supporting history, *(congrats, again GCBs)*.

Last quarter we also pointed out the massive growth in U.S. non-financial corporate debt, and highlighted some of the credit sectors that have been among the fastest growing segments. Then we expanded on our opinion that private credit funds, in general, and direct lending funds, in particular are now liquidity accidents waiting to happen. Investment in these vehicles has become a simple bet that GCBs can prevent a meaningful credit-market, down-cycle beyond the lock-up periods, in our opinion. That previous **Analysis** is reprinted on **page 18**.

At the risk of appearing to be simple news aggregators we think a summary of some recent research and stories neatly paints a picture of ***potential market excess***. One well beyond that provided by the six major EU Sovereign 10-year yields (plus Australia) that have recently experienced somewhat stunning yield declines, to all-time record lows.

Re: U.S. Equities:

J.P. Morgan estimates that **active equity managers account for just 20% of U.S. Equity AUM**, and the rotation from Active to Passive continues! "Based on our estimates, all Passive products are rapidly approaching ~60% of US Equity AUM. Quantitative managers account for an additional ~20% of Equity AUM, leaving discretionary/active mandates at ~20%, of which a sizeable portion has low active share."

— J.P. Morgan Equity Strategy and Quantitative Research, 28 June 2019

Re: Fixed Income ETF's:

"The amount of ***money in fixed-income exchange-traded funds passed $1 trillion last month***...Just 20 years ago, bond ETFs didn't even exist...Thin trading in some of these notes makes it particularly hard to figure out what debt is worth in real time, but ETFs must post the value of their portfolios every 15 seconds. To make this work, the creators of the first fixed income ETFs estimated the value based on other information, like derivatives prices, interest rates or transactions in similar bonds."

— WSJ: 01-Jul-2019, 'Bond Exchange-Traded Funds Pass $1 Trillion in Assets'

Re: Negative Yielding Bonds:

The universe of negative-yielding bonds grew about $1.2 trillion this week after dovish messages from central banks in Europe and the U.S., pushing the total past $13 trillion for the first time...Some 40% of global bonds are now yielding less than 1%, according to data compiled by Bloomberg...It's not just sovereign debt. In the investment-grade market, negative-yielding debt now comprises almost a quarter of the total.

— Bloomberg: 20-Jun-2019 'The World Now Has $13 Trillion of Debt With Below-Zero Yields'

Re: Negative Yielding 'Junk Bonds':

"Central bankers hinting at more monetary stimulus have depressed yields so much that even some European junk bonds trade at levels where investors have to pay for the privilege of holding them.

The number of euro-denominated junk bonds trading with a negative yield -- a status until recently associated with ultra-safe sovereign borrowers -- now stands at 14, according to data compiled by Bloomberg. At the start of the year there were none."

"...High yield borrowers with bonds denominated in euros trading with a negative yield include:

- Ardagh Packaging Finance plc /Ardagh Holdings USA Inc.
- Altice Luxembourg SA
- Altice France SA
- Axalta Coating Systems LLC
- Constellium NV
- Arena Luxembourg Finance Sarl
- EC Finance Plc
- Nexi Capital SpA
- Nokia Corp.
- LSF10 Wolverine Investments SCA
- Smurfit Kappa Acquisitions ULC
- OI European Group BV
- Becton Dickinson Euro Finance Sarl
- WMG Acquisition Corp"

— Bloomberg News: 20-Jun-2019 'The World Now Has $13 Trillion of Debt With Below-Zero Yields'

Re: Morningstar Change to U.S. Bond Fund Classification:

"With little fanfare, many traditionally safe investment-grade bond funds have been edging into more complex corners of fixed income. The goal: to eke out returns in today's low-interest-rate world... many relatively straightforward U.S. bond funds have increased their holdings of lower-rated bonds, emerging-market debt and other securities to juice returns."

"The trend led Morningstar Inc. to change how it classifies U.S. bond funds. In April, the data company broke out two different intermediate bond fund categories. One, called 'intermediate core bond' sticks to U.S.-dollar investment-grade debt, while limiting exposure to below-investment-grade assets. The other, 'intermediate core-plus bond' has more flexibility, typically holding larger positions in emerging-markets and non-U.S.-dollar debt as well as bank loans.

"At some point that category just got bigger and bigger,' said Eric Jacobson, a senior analyst at Morningstar."

e.g. "...the Dodge & Cox Income Fund, has increased the percentage of bonds in its portfolio that are rated one level above junk...assets rated Baa, which are Moody's Investors Service's equivalent of BBB, rose to 32% at the end of last year from 13% at the end of 2006. Such debt comprised 13.6% for the Bloomberg Barclays U.S. Aggregate Index, a benchmark for many core bond funds, at the end of 2018."

"What the illiquidity premium provides, the illiquidity premium will take away in the downturn." {Mike Terwilliger} Great quote!

— Bloomberg News: 05-Jul-2019 'Bond funds drift into risky debt'

Re: Fixed Income 'Quant Strategies':

"Hedge funds, investment banks and sovereign wealth funds are racing to discover the next big thing in fixed income...By carving up corporate bonds into behavioral traits such as value and momentum in the search for alpha, these math wizards are hoping to disrupt the established giants of the trillion-dollar credit market."

"Among recent moves in Europe, Northern Trust Asset Management is raising money for a fund based on credit factors, while a group of ex-BlueBay Asset Management executives are starting a London firm centered on the strategy...Established players include AQR which launched a mutual fund in April 2018 using the same theoretical underpinning in their equity offerings. BlackRock Inc. and Invesco run passive products riding the investing style with more than $500 million in assets combined."

"So far, the performance of mainstream fixed-income factor funds hasn't been electrifying, while the relentless risk rally makes vanilla carry strategies a winning style. But the promise is powerful."

— Bloomberg News: 09-Jul-2019 'The New Quant Billions Are Hiding in the Bond Market'

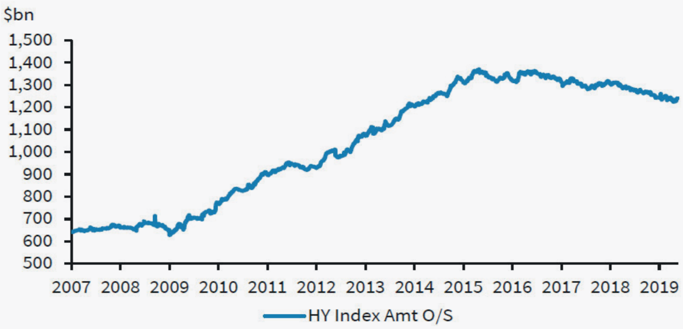
Re: "Bonds Now Account for Less than Half of Total Risk Transfer in the HY market"

Finally, a couple of charts from an excellent (if potentially frightening) research report, entitled:

"The Next Wave of HY Portfolio Products
A Closer Look at TRS and Portfolio Trading"

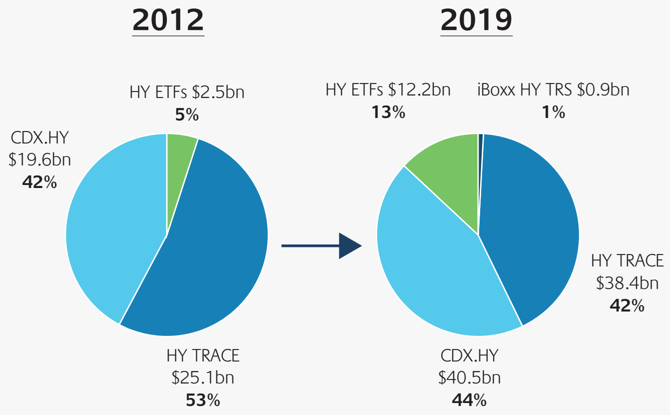
— Barclays, Jigar Patel 06-June-2019

Although HY Index Size Peaked in 2015...



Source: EPFR, NY Fed, Bloomberg, Bloomberg Barclays Indices, Barclays Research

Bonds Now Account for Less than Half of Total Risk Transfer in the HY Market



Note: Charts show average weekly volumes. 2019 data as of mid-May. Source for all charts: Bloomberg, DTCC, Barclays Research

ALL of the above, serves to remind us: **Simple is Good!**

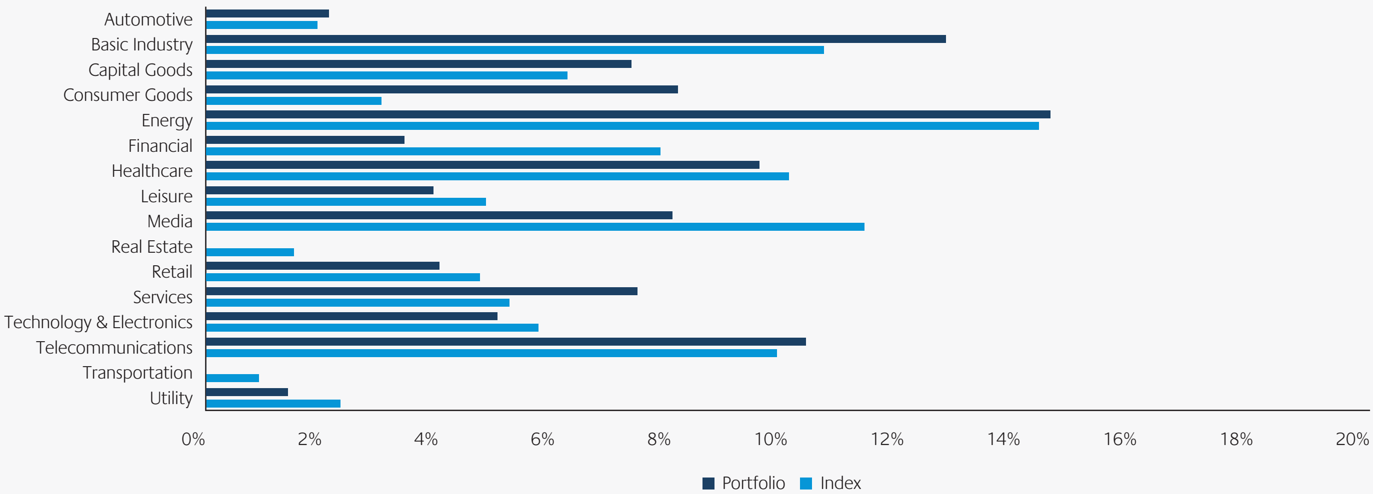
Broad High Yield

Characteristics

	Broad	Index
Yield to Worst*	5.97%	6.04%
Spread to Worst (bps)*	412	419
Duration to Worst (yrs)*	3.75	3.37
# of Issuers	130	
AUM	137	
Avg. Rating	B1/B+	

* Note: Bank loan holdings assume a 3-year refinancing.

Sector weightings: Portfolio, Benchmark



Breakdown by Rating

	Market Value %
BBB-	2.7
BB+	4.5
BB	18.8
BB-	17.2
B+	21.9
B	12.7
B-	13.4
CCC+	3.5
CCC	2.3
Other	0.5

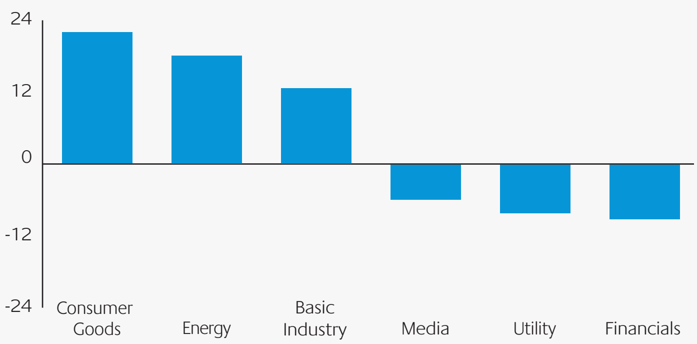
Breakdown by Country

	Risk Contribution %
United States	90.8
Canada	5.5
France	1.4
Australia	1.2
United Kingdom	0.9
Ireland	0.3
Brazil	0.1

Top 10 Issuers

	Market Value %
Bausch Health	2.4
Sprint	2.3
Horizon Pharmaceuticals	1.9
Brookfield Residential	1.7
GEO Group	1.6
Vista Outdoor	1.6
Energizer Holdings	1.6
Reynolds Group	1.6
Asurion	1.6
US Cellular	1.5

Top 3/Bottom 3 Contribution to Excess Return



Note: 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.

Sector & Issuer

Positive Contributors (top three):

Brookfield Residential (BRPCN): Brookfield Residential bonds outperformed during the second quarter on the back of good first quarter earnings performance despite industry malaise. The bonds' performance was also supported by management's constructive commentary on its Ontario market and cautious optimism about traffic during the important spring selling season in the US. The Federal Reserve's accommodating policy rhetoric was also a technical tailwind for longer duration bonds and further substantiated expectations of improving housing demand due to lower financing costs.

Vista Outdoor (VSTO): Vista Outdoor bonds outperformed during the second quarter as the company generated strong free cash flow during the quarter, indicated early signs of a stabilizing consumer ammunition market, and communicated that the Savage brands divestiture process remained underway. We continue to believe the company's management team is focused on addressing expensive secured debt ahead of the bonds with any asset sale proceeds and see the opportunity for further credit improvement on the back of an ammunition market recovery.

JBS USA (JBSSBZ): JBS USA bonds outperformed during the second quarter as favorable beef fundamentals continued to translate into solid first quarter earnings performance. The company has also continued to use free cash flow to pay down debt at both the USA and Brazil entities. The market is also rightly beginning to assess the potential positive impact on global protein pricing resulting from a hog and pork supply shortfall in China (a consequence of an African Swine Flu outbreak). There has also been market speculation that the company will revisit a public listing of the USA entity which could be deleveraging and provide the company with currency to fund acquisitions of prepared foods targets.

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Note: Securities discussed are the largest positive and negative contributors for the specific High Yield strategy.

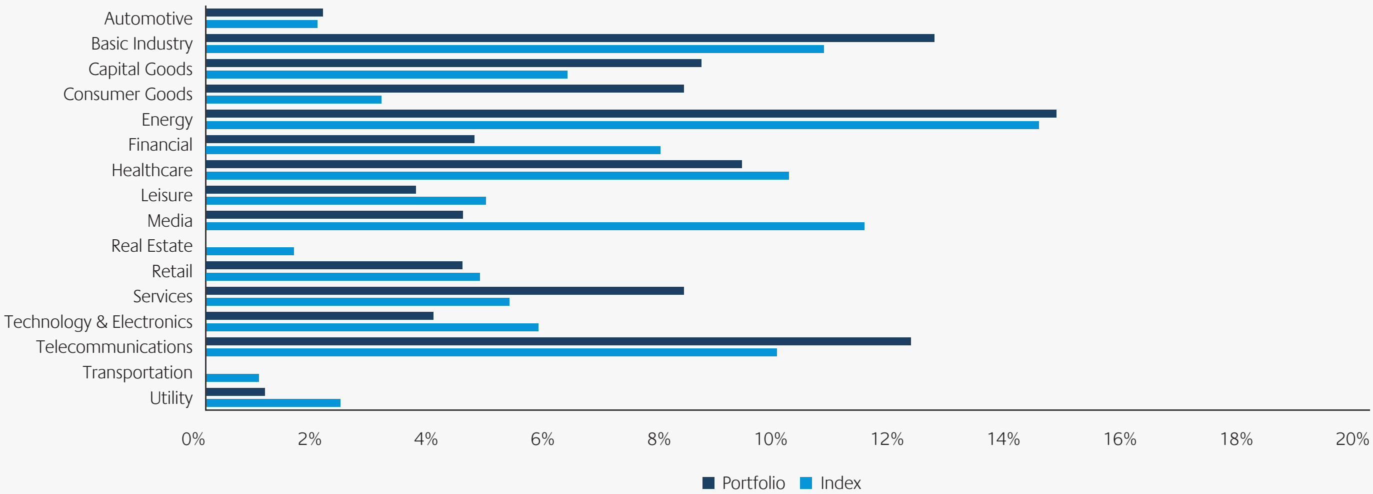
Select High Yield

Characteristics

	Select	Index
Yield to Worst*	6.31%	6.04%
Spread to Worst (bps)*	446	419
Duration to Worst (yrs)*	3.81	3.37
# of Issuers	115	
AUM	63	
Avg. Rating	B2/B+	

* Note: Bank loan holdings assume a 3-year refinancing.

Sector weightings: Portfolio, Benchmark



Breakdown by Rating

	Market Value %
BBB-	2.9
BB+	3.5
BB	15.9
BB-	16.6
B+	19.7
B	10.7
B-	14.9
CCC+	7.5
CCC	5.1
Other	0.2

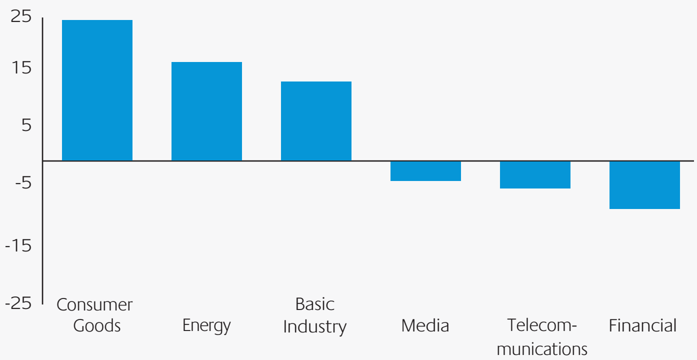
Breakdown by Country

	Risk Contribution %
United States	91.1
Canada	5.8
Australia	0.9
United Kingdom	0.8
France	0.8
Ireland	0.6
Brazil	0.1

Top 10 Issuers

	Market Value %
Bausch Health	2.4
Assured Partners	2.4
Sprint	2.3
Iridium Communications	2.2
Horizon Pharmaceuticals	2.0
Intelsat	1.8
Brookfield Residential	1.8
GEO Group	1.8
Reynolds Group	1.7
Vista Outdoor	1.7

Top 3/Bottom 3 Contribution to Excess Return



Sector & Issuer

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Ascent Resources (ASCRES): Ascent Resources bonds underperformed during the second quarter as the company (and the whole sector) has been hurt by lower natural gas prices. In addition, Ascent is a private company with a higher leverage profile than some of its peers. This is a relatively new name in the portfolio, and we believe that as the company continues to put up good results, they will show meaningful credit improvement that should lead to better trading levels.

Note: Securities discussed are the largest positive and negative contributors for the specific High Yield strategy.

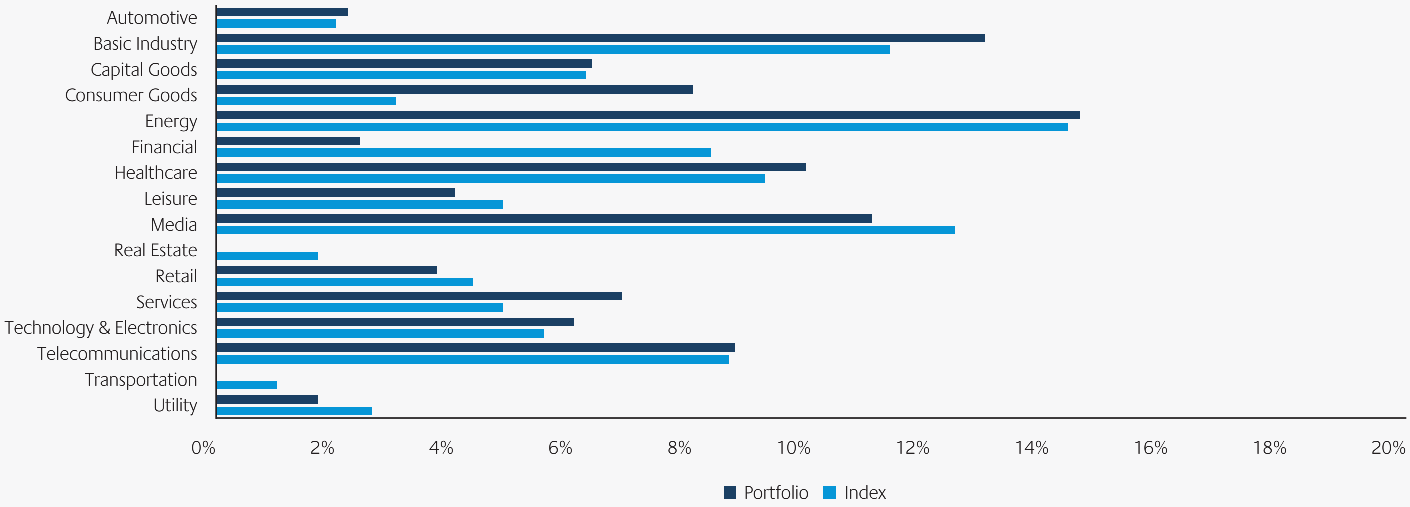
Quality High Yield

Characteristics

	Quality	Index
Yield to Worst*	5.68%	5.37%
Spread to Worst (bps)*	382	352
Duration to Worst (yrs)*	3.70	3.40
# of Issuers	121	
AUM	74	
Avg. Rating	B1/BB-	

* Note: Bank loan holdings assume a 3-year refinancing.

Sector weightings: Portfolio, Benchmark



Breakdown by Rating

	Market Value %
BBB-	2.6
BB+	5.4
BB	21.2
BB-	17.7
B+	23.8
B	14.5
B-	12.2
Other	0.8

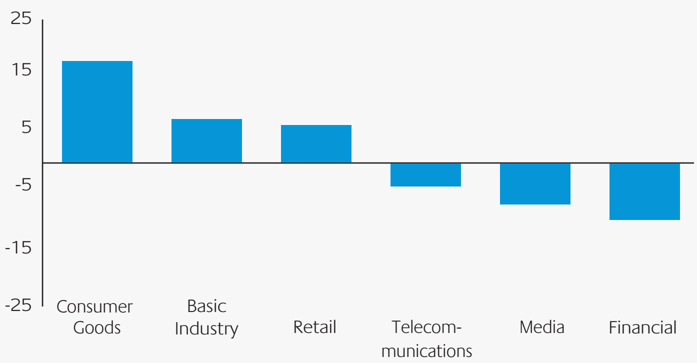
Breakdown by Country

	Risk Contribution %
United States	90.5
Canada	5.2
France	1.9
Australia	1.4
United Kingdom	0.9
Brazil	0.1

Top 10 Issuers

	Market Value %
Bausch Health	2.3
Sprint	2.3
Charter Communications	2.0
Horizon Pharmaceuticals	1.8
Altice	1.7
Brookfield Residential	1.7
Energizer Holdings	1.6
US Cellular	1.6
Vista Outdoor	1.5
GEO Group	1.5

Top 3/Bottom 3 Contribution to Excess Return



Sector & Issuer

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B&G Foods (BGS): B&G Foods bonds outperformed during the second quarter as the market corrected after an overreaction to disappointing fourth quarter earnings and 2019 guidance. Notably, management's 2019 guidance still implied significant free cash flow generation. Support for the notes was also buoyed by the high yield market's strong demand for longer duration higher quality bonds, particularly those trading at lower dollar prices.

Negative Contributors (bottom three):

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Note: Securities discussed are the largest positive and negative contributors for the specific High Yield strategy.

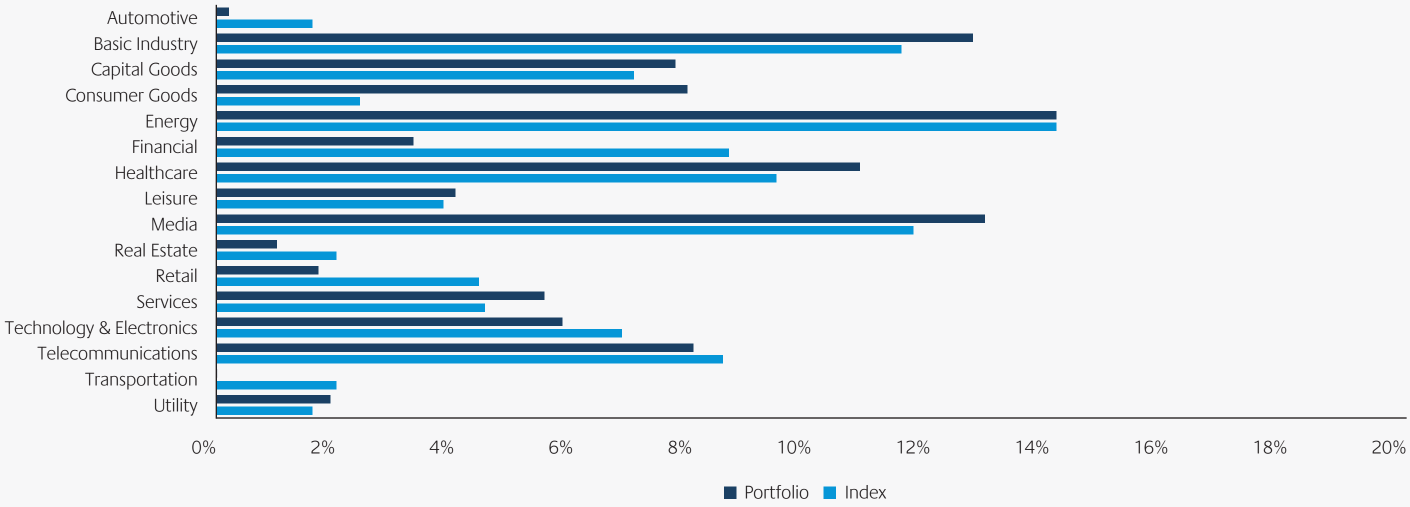
Short Duration High Yield

Characteristics

	Short Duration	Index
Yield to Worst*	4.76%	5.00%
Spread to Worst (bps)*	288	315
Duration to Worst (yrs)*	1.85	1.91
# of Issuers	98	
AUM	51	
Avg. Rating	B1/BB-	

* Note: Bank loan holdings assume a 3-year refinancing.

Sector weightings: Portfolio, Benchmark



Breakdown by Rating

	Market Value %
BBB-	2.1
BB+	6.4
BB	23.4
BB-	19.6
B+	21.0
B	14.3
B-	9.7
Other	0.9

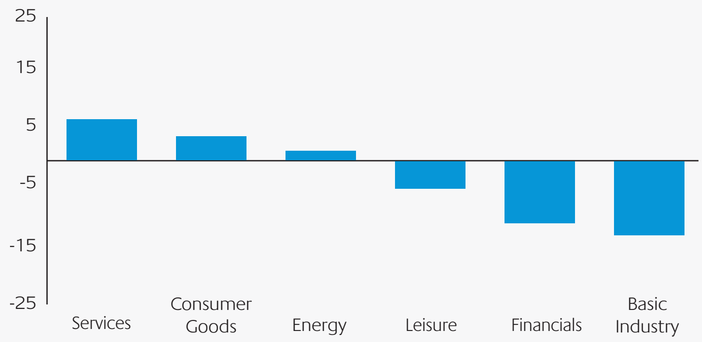
Breakdown by Country

	Risk Contribution %
United States	93.8
Canada	3.7
France	1.3
Ireland	0.5
United Kingdom	0.4
Brazil	0.2
Australia	0.1

Top 10 Issuers

	Market Value %
Sirius XM	2.6
Bausch Health	2.3
Icahn Enterprieses	2.2
Sprint	2.1
Reynolds Group	2.1
Altice USA	2.1
Level III	2.1
Clear Channel	2.1
Dell	2.0
Charter Communications	2.0

Top 3/Bottom 3 Contribution to Excess Return



Sector & Issuer

Positive Contributors (top three):

Vista Outdoor (VSTO): Vista Outdoor bonds outperformed during the second quarter as the company generated strong free cash flow during the quarter, indicated early signs of a stabilizing consumer ammunition market, and communicated that the Savage brands divestiture process remained underway. We continue to believe the company's management team is focused on addressing expensive secured debt ahead of the bonds with any asset sale proceeds and see the opportunity for further credit improvement on the back of an ammunition market recovery.

Peabody Energy (BTU): Peabody Energy bonds outperformed during the second quarter after the company announced a significant joint venture with Powder River Basin peer, Arch Coal. The restrictive covenants in the bond indenture are likely to result in some type of consent payment or early refinancing in order for the joint venture transaction to be consummated. Consequently, the bonds traded up on the news.

Sprint (S): Sprint outperformed during the second quarter after an FCC approval of the merger with T-Mobile. A combination with T-Mobile would result in a larger, more competitive wireless player with better positioning to build out a 5G network than standalone Sprint. Bonds rallied on the higher likelihood that the deal would receive full regulatory approval. Sprint is still awaiting DoJ approval and there are ongoing discussions.

Negative Contributors (bottom three):

Chemours (CC): Chemours underperformed during the quarter due to the confluence of disappointing 1Q19 results and a significant uptick in litigation and regulatory actions related to legacy DuPont environmental matters. While Chemours enjoys a very strong asset base and we expect earnings will improve over time, we believe the widening scope of legacy environmental issues poses risk to the credit and will remain an ongoing overhang. Therefore, we decided to exit our position during the quarter, as we believed that bond prices did not overcompensate for the increased risk profile.

Endo International (ENDP): Endo's underperformance during the quarter was mainly due to the continued focus on opioid litigation risk. While the Oklahoma case (against JNJ) is still ongoing and the first track of MDL is not due to start until October, Endo's bonds have reacted negatively to all headlines related to opioid suits. However, we continue to hold the bonds (mainly secured notes) given our belief that 1) results are likely to benefit from new product launches over the next few years (including launch of Xiaflex for Cellulite in 2020) and 2) any opioid litigation settlement is likely to be an unsecured claim of manageable magnitude for the company.

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Note: Securities discussed are the largest positive and negative contributors for the specific High Yield strategy.

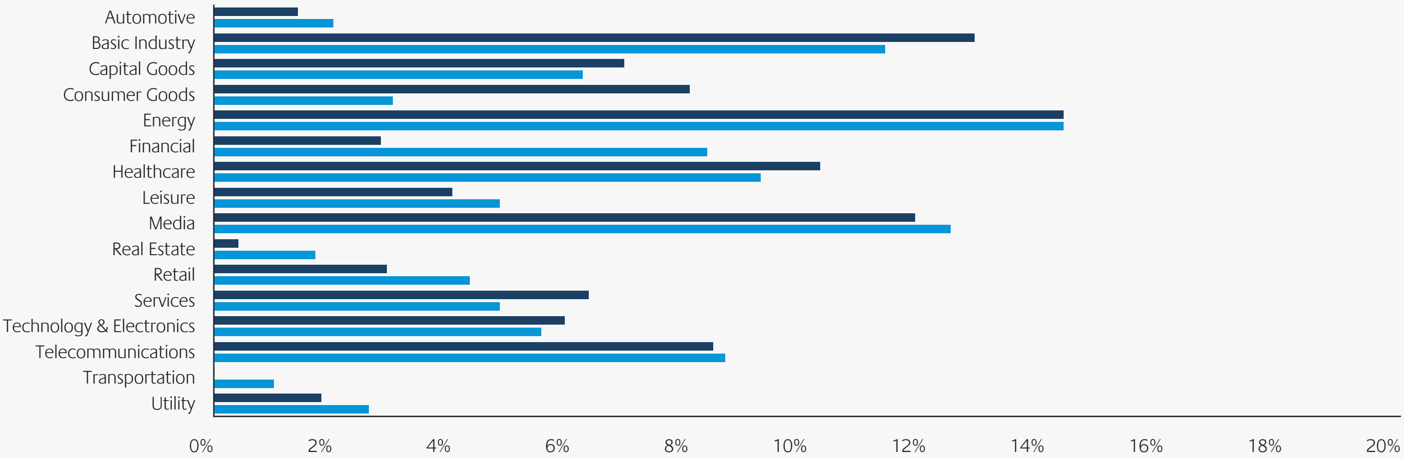
Defensive High Yield

Characteristics

	Defensive	Index
Yield to Worst*	5.30%	5.37%
Spread to Worst (bps)*	344	352
Duration to Worst (yrs)*	2.95	3.40
# of Issuers	142	
AUM	125	
Avg. Rating	B1/BB-	

* Note: Bank loan holdings assume a 3-year refinancing.

Sector weightings: Portfolio, Benchmark



Breakdown by Rating

	Market Value %
BBB-	2.4
BB+	5.8
BB	22.1
BB-	18.5
B+	22.6
B	14.4
B-	11.2
Other	0.8

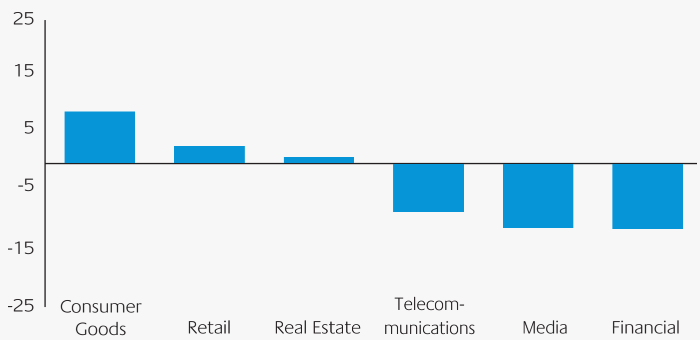
Breakdown by Country

	Risk Contribution %
United States	91.8
Canada	4.6
France	1.7
Australia	0.9
United Kingdom	0.7
Ireland	0.2
Brazil	0.1

Top 10 Issuers

	Market Value %
Bausch Health	2.3
Sprint	2.2
Charter Communications	2.0
Altice USA	1.9
Sirius XM	1.8
Horizon Pharmaceuticals	1.8
Reynolds Group	1.7
Clear Channel	1.6
Icahn Enterprises	1.6
PDC Energy	1.6

Top 3/Bottom 3 Contribution to Excess Return



Note: The Defensive High Yield strategy is a hypothetical portfolio. The assets within the Short Duration High Yield strategy and Quality High Yield strategy have been combined to create the FSI Defensive High Yield strategy.

Sector & Issuer

Positive Contributors (top three):

Vista Outdoor (VSTO): Vista Outdoor bonds outperformed during the second quarter as the company generated strong free cash flow during the quarter, indicated early signs of a stabilizing consumer ammunition market, and communicated that the Savage brands divestiture process remained underway. We continue to believe the company's management team is focused on addressing expensive secured debt ahead of the bonds with any asset sale proceeds and see the opportunity for further credit improvement on the back of an ammunition market recovery.

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Bausch Health (BHCCN): Bausch Health bonds outperformed in the second quarter as the company reported better than expected results for 1Q19, raised full year guidance, and partially addressed the 2023 maturity wall through new issuance and free cash flow. We believe that management will remain focused on debt reduction over the next few years and see the credit benefitting from its strong eye care business and low exposure to prescription drugs/opioids.

Negative Contributors (bottom three):

Chemours (CC): Chemours underperformed during the quarter due to the confluence of disappointing 1Q19 results and a significant uptick in litigation and regulatory actions related to legacy DuPont environmental matters. While Chemours enjoys a very strong asset base and we expect earnings will improve over time, we believe the widening scope of legacy environmental issues poses risk to the credit and will remain an ongoing overhang. Therefore, we decided to exit our position during the quarter, as we believed that bond prices did not overcompensate for the increased risk profile.

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Note: Securities discussed are the largest positive and negative contributors for the specific High Yield strategy.

Co-Portfolio Managers: High Yield

Jason Epstein
Senior Portfolio Manager

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,
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.

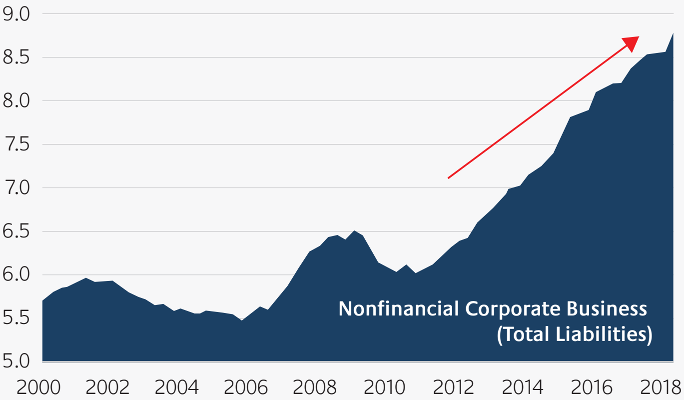
Analysis: Private "Free Lunch" Funds

In our "Thoughts on the Market" we pointed out that we find the investment management industry predictable, if nothing else. Investment managers never let a bull-market go to waste in pursuit of higher fees via financial engineering.

Every market participant has their own views as to the relative value and suitability of the myriad of investment alternatives offered in the markets. We do not aim to force our own views on anyone else. Rather, we hope to point out some simple trends others may find "food for thought."

As a starting point, most every reader can probably agree that corporate debt has experienced a noticeable increase over the past 5 years, or so. We reference the following graph as representative of this overall trend, in the U.S. alone. Fans of data crunching can reference table L.103 in the Fed's most recent Z.1: Financial Accounts of the United States.

Exhibit 2: By contrast, non-financial corporate debt has meaningfully grown



Source: Federal Reserve Board, Goldman Sachs Global Investment Research

Armed only with Bloomberg and Google we can observe some interesting corporate debt trends, we think. Consider the approximate growth of select market segments over the past ~5 years:

Asset Class	Source	2013	2018	% Change	$ Change
U.S. High Yield	BofA	1,082.9	1,128.8	4%	45.9
U.S. Leveraged Loan	BofA	682.6	1,148.5	68%	465.9
		1,765.5	2,277.3	29%	511.8
U.S. High Grade Corp	BofA	4,672.3	6,400.3	37%	1,728.0
U.S. BBB Corporates	*BofA*	*2,120.8*	*3,207.0*	*51%*	*1,086.2*
BBBs / Total HG Corps		*45%*	*50%*		***63%***
Private Debt **	Prequin	457.0	769.0	68%	312.0
Direct Lending	*Prequin*		*252.0*		
Distressed Debt	*Prequin*		*231.0*		
Mezzannine	*Prequin*		*163.0*		
Special Situations	*Prequin*		*109.0*		
Venture Debt	*Prequin*		*14.0*		
Private Equity	Prequin	2,177.0	3,411.0	57%	1,234.0
Hedge Funds	Prequin	--	3,526.0	--	--

*** Prequin data as of Jun-2018*

We usually point out that High Yield bonds seem to be most market pundits' favorite punching bag; which makes sense to us since most market pundits seem to be negative barometers. We believe 30+ years of High Yield market history make a strong case for High Yield without much commentary, however we find some information from the table above to be very interesting:

- The cumulative 5-year growth rate in the face amount of the BofA **High Yield market** is only +4% = +46 billion
- The cumulative 5-year growth rate in the face amount of the BofA **Leveraged Loan market** is +68% = +466 billion
- The cumulative 5-year growth rate in the face amount of the BofA **High Grade Corporate market** is +37% = +1.728 trillion
- 63% of the growth of the BofA High Grade Corp market has been due to a +1.086 trillion increase in ***BBB-rated bonds***.

We don't know all of the reasons the High Yield corporate bond market has been approximately unchanged in size over the past 5 years, at a time when overall corporate debt in the U.S. has been exploding higher as shown in ***Exhibit 1***. However, it seems reasonable to assume one reason is that the leveraged loan market has been more attractive to, and/or more accessible to non-investment grade issuers.

Another likely explanation is the "shadow banking system"!

A term so apparently disturbing that the Financial Stability Board (FSB) announced on Feb, 4 2019: *"With the 2018 Report, the FSB moves away from the term **"shadow banking"** and adopts **"nonbank financial intermediation" (hereafter NBFI)…"***
FYI: The FSB monitors and makes recommendations about the global financial system and is hosted and funded by the Bank for International Settlements in Basel, Switzerland.

In any case, Alternative Asset Classes, including "Private Credit Funds" (PCFs) have attracted a seemingly massive amount of investor money over this same 5-year period, ("massive" means we really don't know how much). We suspect PCFs have also displaced some High Yield issuance in those instances where a consortium of investors split a larger direct lending loan. The largest use of direct lending proceeds over the last 5-years has been for funding LBO's. Yet with the "sweet spot" of direct lending loans only $20-50 mm in size it's uncertain how significant the displacement of High Yield financings has been.

However, the topic of PCFs in general, and Direct Lending credit funds in particular, does afford the opportunity to circle back to the core topic of pursuit **financial engineering in the pursuit of higher fees.**

We have previously opined on **Direct Lending credit funds** (1Q'18) and the growth of that market has continued, unabated. The mantra of direct lending proponents remains: significant yield premium, secured loans, stronger covenants, shorter average maturities and no mark-to-market "nuisance."

The inherent risks have continued to increase, as well, we think.

- **Demand for Deal Flow.** We observe too much capital raised relative to the size of the quality opportunity set of the asset class. Money on the sidelines doesn't pay for a Hamptons house. The less scrupulous managers search for loan supply as a miniature reminder of the demand for subprime-MBS, pre-GFC. Even the scrupulous managers compromise on covenants, security etc.

- **Mark-to-Market?** The vast majority of High Yield bonds are priced each day based on realistic broker-dealer markets. Because this is not true for most direct lending loans the temptation and ability to hide credit problems exists. A borrower can't pay? Restructure the loan: reduce or suspend coupon payments or push out maturities. If the lost coupon problem presents a problem, add a little more leverage to the portfolio. Investors who don't think this is common may be too "trusting." We don't know, "for sure."
- **Terms.** We are hearing of 10-year lock-up periods? It seems to us a full decade is pushing the limits re: *"sooner or later"* is *"late enough."*

  Direct Lending also presents a couple of inherent structural disadvantages, through the lens of our High Yield investment process:
- **Average Loan Size.** Our High Yield investment process begins with a mechanical screen that would immediately eliminate most direct lending from consideration. We typically avoid High Yield issuers with less than $150 mm of bonds; not primarily because of trading liquidity concerns, but rather our experience that such issuers tend to be less strategic in their industries; in terms of market share, costs or other sustainable competitive advantage.
- **Illiquidity.** The general lack of tradable liquidity in the direct lending market would also eliminate one of the critical advantages of our investment process. We are typically light on credit risk when our market corrects from relatively full valuation levels. Our ability to rotate into higher total return credits on market breaks is our key opportunity to position for our strongest total return periods.

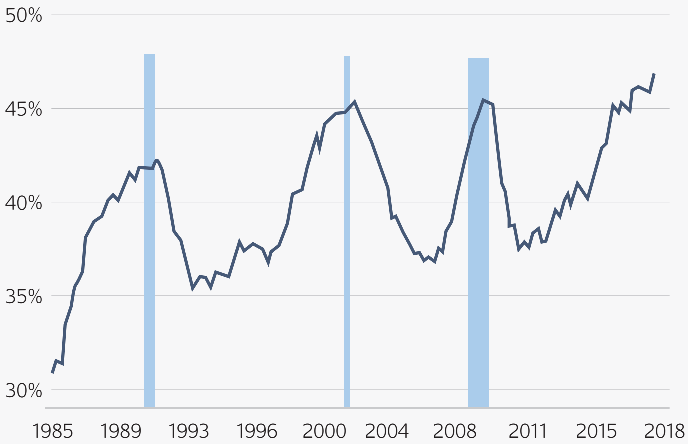
We don't single-out Direct Lending credit funds for any reason except they operate in a non-investment grade world we know something about. We readily assume that the flood of investor money into every flavor of PCFs has produced general excesses across the board.

Our message to investors is that now, more than ever, **Simple is Good!**

Our High Yield investment process is designed to handle market volatility and downside corrections. As PMs we have a proven record of calmly taking advantage of the opportunities they present while remaining focused on the preservation of capital.

We respect the power of GCBs and massive monetary stimulus. We also respect a record amount of nonfinancial corporate debt and the shadow banking system's strengths and weaknesses. The following cheerful graph accompanied a recent article in Forbes that highlighted David Rosenberg's prediction of a recession in 2H-2019; NOT a view we share. Nevertheless, the graph is at least worthy of consideration if investors are making a de facto bet that GCBs can indefinitely keep ***"sooner or later"*** at bay.

Exhibit 3:
Nonfinancial Corporate Debt-GDP Has Exceeded Record Levels
Through November 2018



Source: BBVA Research, Federal Reserve, U.S. Global Investors

Perhaps this time IS different. If so, the critical question then becomes HOW different.