For qualified investors only

First State Investments

Quarterly Update | Global High Yield

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Q3 2017 | Co-Portfolio Managers: Matt Philo, Mike Elkins & Jason Epstein

Thoughts on the Market

"Happy Anniversary"?

We begin this Quarter's commentary by acknowledging, as a number of market commentators have done, that October 9th marked the 10th anniversary of the S&P 500's pre-Global Financial Crisis (GFC) peak.

The +104% total return of the S&P 500 over this 10-year period is impressive, but hardly a surprise to anyone watching the relentless climb of U.S. stocks.

More surprising, is the BAML U.S. High Yield Constrained Index's (HUC0) total return over the same 10-year period: +110.9% (113.4% from income & -2.5% in price).

Ten years is a long time, but the memory of the GFC is still fresh in the minds of seasoned portfolio managers: New Century, Countrywide, FNM/FRE, Bear Stearns, Merrill Lynch, Lehman, AIG & Goldman Sachs…the bank holding company! Just when you think you've seen it all, the market reminds you: you've only seen a lot.

However, our high yield investment process has not changed since its origin in the 1990's, with its nearly forgotten legacy connection to a deep value equity group. We look for minimum margin-of-safety requirements, catalysts for credit improvement/total return, and yields and spreads that over-compensate for estimated default risk: the drum beat of our careers.

This investment process forces us into and out of relative credit risk in such a way that we don't fear market volatility or downside corrections. We calmly welcome the opportunities they present to rotate into higher total return investments. And through it all, we operate with the wind at our backs; wind in the form of current income typically amongst the highest of any global fixed income asset class. "Happy Anniversary" indeed.

High Yield Market Overview

The high yield markets have continued their very strong rally from their February 2016 lows. Every market environment presents investors with somewhat unique market internals, opportunities and challenges.

Our investment process has yet to experience a market environment where it can't identify a fully diversified high yield portfolio that overcompensates for estimated default risk. The key for us is always the same: successfully follow our investment process and allow it to guide our portfolios to the best available default adjusted value.

The implementation of our investment process currently reflects a portfolio positioning driven by the single most challenging market dynamic presented by today's high yield market:

A significantly smaller **opportunity set** of high yield securities that meet both our minimum margin-of-safety requirements, AND over-compensate in yield and spread, for our estimates of their individual default risks.

In fact, we currently observe one of the narrowest, perhaps the narrowest opportunity set in our high yield market careers.

(Note: "**Analysis: High Yield Market Internals**" at the end of this Quarterly Update, studies the narrowed opportunity set in some detail).

Portfolio Positioning

Currently, the ongoing disciplined implementation of our investment process results in a Broad High Yield portfolio with characteristics that reflect an adaptation to the current market environment.

Most notably, our nine largest issuer weightings are all high conviction, total return positions whose weightings bear little resemblance to those in the high yield benchmark. For example, these nine holdings comprise 20.1% of Broad vs. 4.3% in the Index; and as a group, a Yield to Worst of 6.55% vs. the Index's 5.47%.

In our view, the current high yield market presents this opportunity due to the typical hot market phenomena: a general increase in herd mentality and the stealth reappearance of closet indexers (after some disarray/dismay during the low tides of the 1.5+ years of risk correction into the early-2016 low).

Also notable, is that current market internals result in optimal composite portfolios with issuer counts towards the lower-end of the ranges we highlight as "typical." This portfolio positioning is neither a positive, or negative in the absolute as our portfolios remain very comfortably, "fully diversified" by any measure of statistical relevance, in our estimation. The lower issuer count is simply a function of the much smaller than normal, universe of opportunities; a residual of the calm, and disciplined implementation of our investment process. However, it's fortuitous that our current capability to own these optimal portfolios is at a maximum, despite overall market liquidity below the market norms. In other words, this relatively new high yield team's relatively "old" high yield Co-PM's fully appreciate our current excess flexibility and mobility. Timing is very far from everything, but it presents opportunity.

Composite Performance Summary

Institutional Composites and Benchmarks	1 month	3 months	Since inception 5/01/17*	AUM ($m)
Broad High Yield	0.99	2.04	3.34	242
BofA Merrill Lynch US High Yield Constrained Index: HUC0	0.90	2.04	3.05	
Composite vs. Benchmark	**0.09**	**0.00**	**0.29**	
Select High Yield	1.04	1.92	3.26	75
BofA Merrill Lynch US High Yield Constrained Index: HUC0	0.90	2.04	3.05	
Composite vs. Benchmark	**0.14**	**-0.11**	**0.21**	
Quality High Yield	0.96	2.09	3.37	167
BofA Merrill Lynch BB-B US High Yield Constrained Index: HUC4	0.78	1.94	2.93	
Composite vs. Benchmark	**0.18**	**0.15**	**0.45**	
Short Duration High Yield	0.73	1.71	2.39	40
BofA Merrill 1-5 yr BB-B US Cash Pay HY Constrained Index: JVC4	0.61	1.45	2.28	
Composite vs. Benchmark	**0.12**	**0.26**	**0.12**	

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

Broad High Yield

This strategy has the widest high yield market opportunity set. The benchmark is the Bank of America Merrill Lynch US High Yield Constrained Index. The excess return target is 100bp.*

Composite Performance

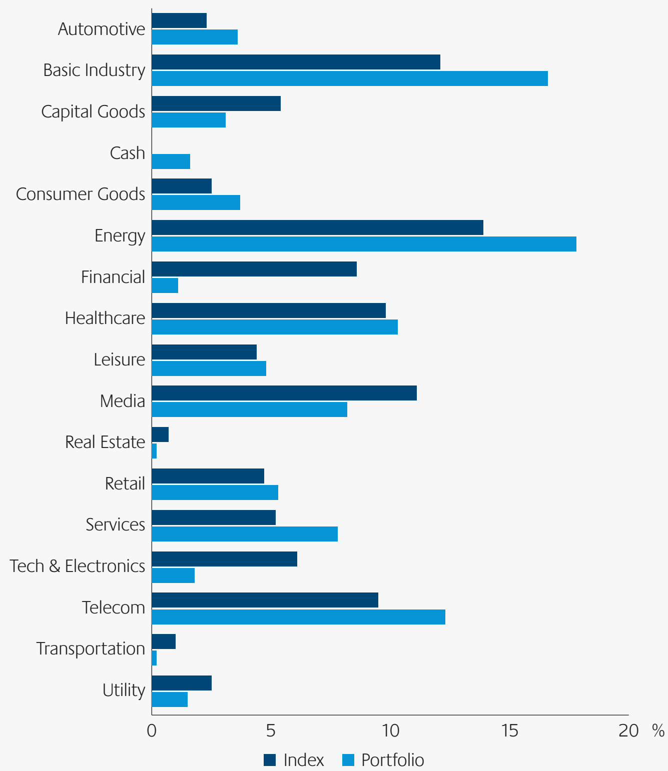
Broad High Yield returned 2.04% for Q3'17, which was in line with the BofA Merrill Lynch US High Yield Constrained Index. Since inception on May 1st, 2017, Broad High Yield has outperformed its Index by 29bps.

Characteristics

	Broad	Index
Yield to Worst	5.22%	5.42%
Spread to Worst	340	368
Duration to Worst	3.65	3.52
# of Issuers	137	864
Avg. Rating	B1/B+	B1

* Excess return targets are solely intended to express an objective for a return on your investment and represents a forward looking statement. It does not represent and should not be construed as a guarantee, promise, or assurance of a specific return on you investment. For additional information regarding forward looking statements please see the disclaimer page.

Sector weightings: Portfolio, Benchmark



Breakdown by Rating

Security Description	Market Value %
A+ (Cash)	1.6%
BBB-	2.1%
BB+	6.5%
BB	11.7%
BB-	22.8%
B+	23.8%
B	17.3%
B-	12.0%
CCC+	1.7%
CCC	0.4%

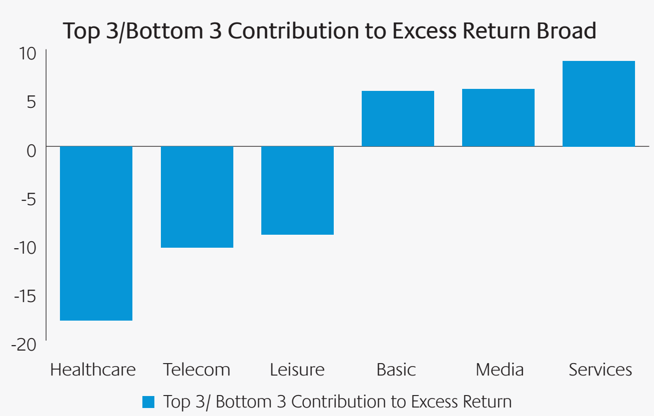
Breakdown by Country

Security Description	Market Value %
United States	87.8%
Canada	6.1%
France	5.3%
United Kingdom	0.5%
Ireland	0.2%

Top 10 Issuers

Security Description	Market Value %
Altice International	2.8%
Donnelley Financial Solutions Inc	2.5%
Intelsat SA	2.4%
Rite Aid Corp	2.2%
Valeant Pharmaceuticals International Inc	2.2%
Cincinnati Bell Inc	2.0%
Endo International PLC	2.0%
Peabody Energy Corp	2.0%
Frontier Communications Corp	1.9%
Sprint Corp	1.6%

Sector & Issuer Commentary



Positive Contributors:

Services, **Media**, and **Basic Industry** were the sectors that added the most positive alpha during the quarter.

Services: Hertz Global (HTZ), we capitalized on attractive relative value in a new second lien bond in the capital structure after a sell-off driven by concerns regarding the company's operational execution, in particular; and worries over the state of the car rental industry, in general.

Media: Performance in Media was largely driven by a diverse group of holdings that included several television broadcasters. Issuer selection played a particularly important role generating excess return in this sector.

Basic Industry: Peabody Energy (BTU) was our largest contributor to active performance for the third quarter. We view the issuer as a core holding due to its strong asset coverage, significant free cash flow generation, first lien security, management's balanced capital allocation strategy, and attractive risk-adjusted relative value.

Negative Contributors:

Healthcare, **Telecom**, and **Leisure** were the sectors that detracted the most negative alpha during the quarter.

Healthcare: Kindred Healthcare (KND) underperformed due primarily to an unexpected announcement proposing sharp reductions in government reimbursement rates that could negatively impact the company's Home Health business unit. More broadly across Healthcare we benefited by rotating out of our levered hospital exposure and increasing our position in pharmaceutical credits where we identified a few attractive opportunities in secured debt and near term maturities.

Telecommunications: Cincinnati Bell (CBB) underperformed as the company surprised the market by announcing its intent to acquire two companies. We believe the acquisitions will prove near leverage neutral, are strategically sound and will broaden the company's business. Management has historically invested capital well and we expect results to prove that out over coming quarters.

Leisure: AMC Entertainment (AMC) dragged down the Leisure sector. While poor box-office results are impacting the entire industry, AMC's results were magnified by its integration of recently acquired assets that temporarily increased fixed costs. Management communicated a plan to reduce operating costs going forward and has already completed several asset sales earmarked to reduce leverage. The position has since rebounded sharply.

Securities discussed are the largest positive and negative contributors for the specific sectors.

Select High Yield

This is a more concentrated strategy in high conviction ideas. The benchmark is the Bank of America Merrill Lynch US High Yield Constrained Index. The excess return target is 150bp.

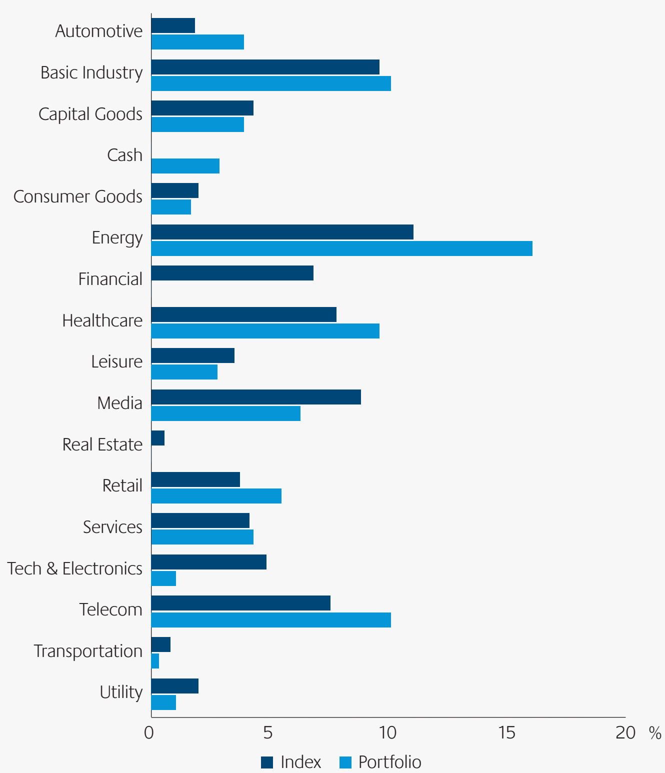
Composite Performance

Select High Yield returned 1.92% for Q3'17, which underperformed the BofA Merrill Lynch US High Yield Constrained Index by 11bps. Since inception on May 1st, 2017, FSI Select High Yield has outperformed its Index by 21bps.

Characteristics

	Select	Index
Yield to Worst	5.33%	5.42%
Spread to Worst	353	368
Duration to Worst	3.6	3.52
# of Issuers	93	864
Avg. Rating	B2/B+	B1

Sector weightings: Portfolio, Benchmark



Breakdown by Rating

Security Description	Market Value %
A+ (Cash)	3.6%
BBB-	2.0%
BB+	3.4%
BB	9.5%
BB-	19.1%
B+	23.2%
B	19.6%
B-	15.5%
CCC+	2.5%
CCC	1.4%

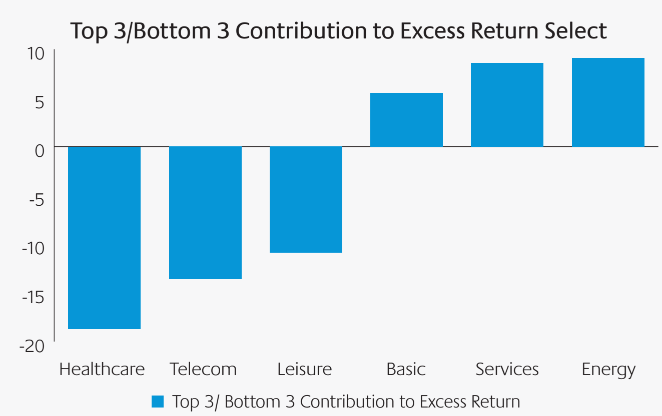
Breakdown by Country

Security Description	Market Value %
United States	88.8%
Canada	5.3%
France	4.9%
Ireland	0.6%
United Kingdom	0.4%

Top 10 Issuers

Security Description	Market Value %
Valeant Pharmaceuticals International Inc	3.2%
Altice International	3.1%
Intelsat SA	2.9%
Rite Aid Corp	2.9%
Halcon Resources Corp	2.8%
Endo International PLC	2.6%
Donnelley Financial Solutions Inc	2.5%
BWAY Holding Co	2.1%
Cincinnati Bell Inc	2.1%
Gates Global Co	2.1%

Sector & Issuer Commentary



Positive Contributors:

Energy, **Services**, and **Basic Industry** were the sectors that added the most positive alpha during the quarter.

Energy: **Oasis Petroleum (OAS)** performed well amongst a group of portfolio holdings in the E&P Sector that made a meaningful positive contribution to performance. While performance benefited from higher oil prices in the third quarter, we have continued to focus on higher quality E&P issuers, estimated to present high levels of asset value coverage that would withstand potential volatility of commodity prices.

Services: **Herc Rentals (HERCRE)** experienced tightening bond spreads following the equipment rental company's strong operating performance.

Basic Industry: **Peabody Energy (BTU)** was our largest contributor to active performance for the third quarter. We view the issuer as a core holding due to its strong asset coverage, significant free cash flow generation, first lien security, management's balanced capital allocation strategy, and attractive risk-adjusted relative value. We also saw broad gains across our **Homebuilding / Building Materials** positions during the quarter.

Negative Contributors:

Healthcare, **Telecom**, and **Leisure** were the sectors that detracted the most negative alpha during the quarter.

Healthcare: **Kindred Healthcare (KND)** underperformed due primarily to an unexpected announcement proposing sharp reduction in government reimbursement rates that could negatively impact the company's Home Health business unit. More broadly across Healthcare we benefited by rotating out of our levered hospital exposure while increasing our position in pharmaceutical credits where we identified a few attractive opportunities in secured debt and near term maturities.

Telecommunications: **Cincinnati Bell (CBB)** underperformed as the company surprised the market by announcing its intent to acquire two companies. We believe the acquisitions will prove near leverage neutral, are strategically sound and will broaden the company's business. Management has historically invested capital well and we expect results to prove that out over coming quarters.

Leisure: **AMC Entertainment (AMC)** dragged down the Leisure sector. While poor box-office results are impacting the entire industry, AMC's results were magnified by its integration of recently acquired assets that temporarily increased fixed costs. Management communicated a plan to reduce operating costs going forward and has already completed several asset sales earmarked to reduce leverage. The position has since rebounded sharply.

Quality High Yield

This strategy is focused on the higher quality segment of the High Yield market. The benchmark is the Bank of America Merrill Lynch US High Yield BB-B Constrained Index. The excess return target is 100bp.

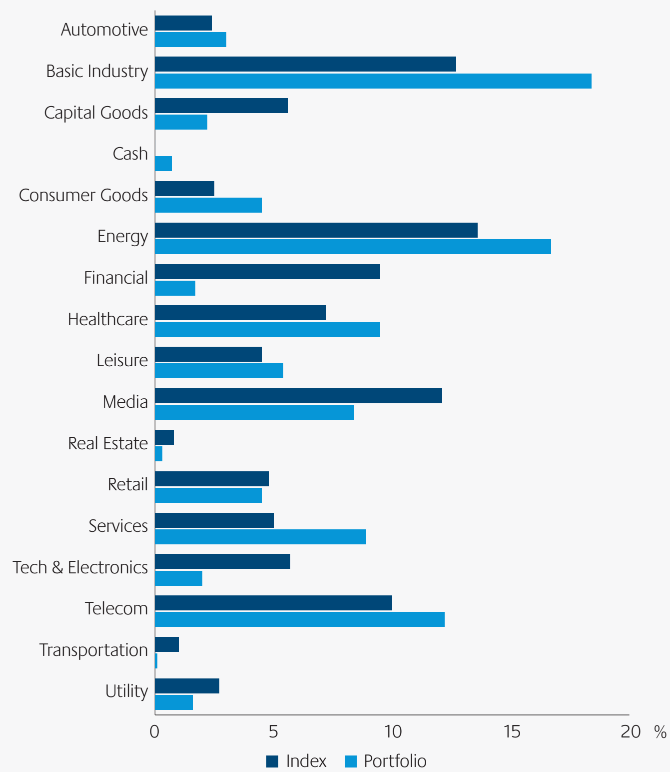
Composite Performance

Quality High Yield returned 2.09% for Q3'17, which outperformed the BofA Merrill Lynch BB-B US High Yield Constrained Index by 15bps. Since inception on May 1st, 2017, Quality High Yield has outperformed its Index by 45bps.

Characteristics

	Quality	Index
Yield to Worst	5.17%	4.63%
Spread to Worst	335	285
Duration to Worst	3.67	3.62
# of Issuers	130	676
Avg. Rating	B1/B+	BB3

Sector weightings: Portfolio, Benchmark



Securities discussed are the largest positive and negative contributors for the specific sectors.

Breakdown by Rating

Security Description	Market Value %
A+ (Cash)	0.7%
BBB-	2.1%
BB+	7.9%
BB	12.7%
BB-	24.4%
B+	24.0%
B	16.3%
B-	10.5%
CCC+	1.3%

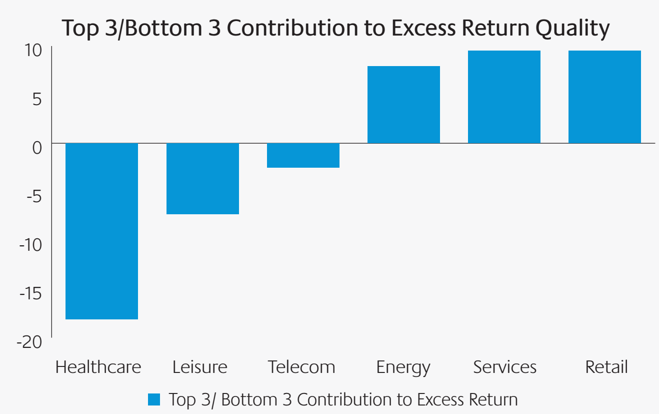
Breakdown by Country

Security Description	Market Value %
United States	87.5%
Canada	6.4%
France	5.6%
United Kingdom	0.6%

Top 10 Issuers

Security Description	Market Value %
Altice International	2.6%
Donnelley Financial Solutions Inc	2.6%
Intelsat SA	2.2%
Peabody Energy Corp	2.0%
Cincinnati Bell Inc	2.0%
Rite Aid Corp	2.0%
Frontier Communications Corp	1.8%
Valeant Pharmaceuticals International Inc	1.8%
Endo International PLC	1.8%
HERC Holdings Inc	1.6%

Sector & Issuer Commentary



Positive Contributors:

Retail, **Services**, and **Energy** were the sectors that added the most positive alpha during the quarter.

Retail: **Penske Automotive (PAG)** is a car dealer that we favoured due to its strong market position, low leverage, and high asset coverage. We benefited from not owning many high profile retail names pressured by continuing concerns regarding the sustainability of the brick & mortar business model. We also benefited from no exposure to the Supermarket sector, which was negatively impacted by Amazon's acquisition of Whole Foods.

Services: **Herc Rentals (HERCRE)** experienced tightening bond spreads following the equipment rental company's strong operating performance.

Energy: **Oasis Petroleum (OAS)** performed well amongst a group of portfolio holdings in the E&P Sector that made a meaningful positive contribution to performance. While performance benefited from higher oil prices in the third quarter, we have continued to focus on higher quality E&P issuers, estimated to present high levels of asset value coverage that would withstand potential volatility of commodity prices.

Negative Contributors:

Healthcare, **Telecom**, and **Leisure** were the sectors that detracted the most negative alpha during the quarter.

Healthcare: **Kindred Healthcare (KND)** underperformed due primarily to an unexpected announcement proposing sharp reduction in government reimbursement rates that could negatively impact the company's Home Health business unit. More broadly across Healthcare we benefited by rotating out of our levered hospital exposure while increasing our position in pharmaceutical credits where we identified a few attractive opportunities in secured debt and near term maturities.

Telecommunications: **Cincinnati Bell (CBB)** underperformed as the company surprised the market by announcing its intent to acquire two companies. We believe the acquisitions will prove leverage neutral, are strategically sound and will broaden the company's business. Management has historically invested capital well and we expect results to prove that out over coming quarters.

Leisure: **AMC Entertainment (AMC)** dragged down the Leisure sector. While poor box-office results are impacting the entire industry, AMC's results were magnified by its integration of recently acquired assets that temporarily increased fixed costs. Management communicated a plan to reduce operating costs going forward and has already completed several asset sales earmarked to reduce leverage. The position has rebounded sharply.

Securities discussed are the largest positive and negative contributors for the specific sectors.

Short Duration High Yield

This is a more defensive strategy with limited interest rate exposure. The benchmark is the Bank of America Merrill Lynch 1-5 Year BB-B Cash Pay High Yield Constrained Index. The excess return target is 100bp.

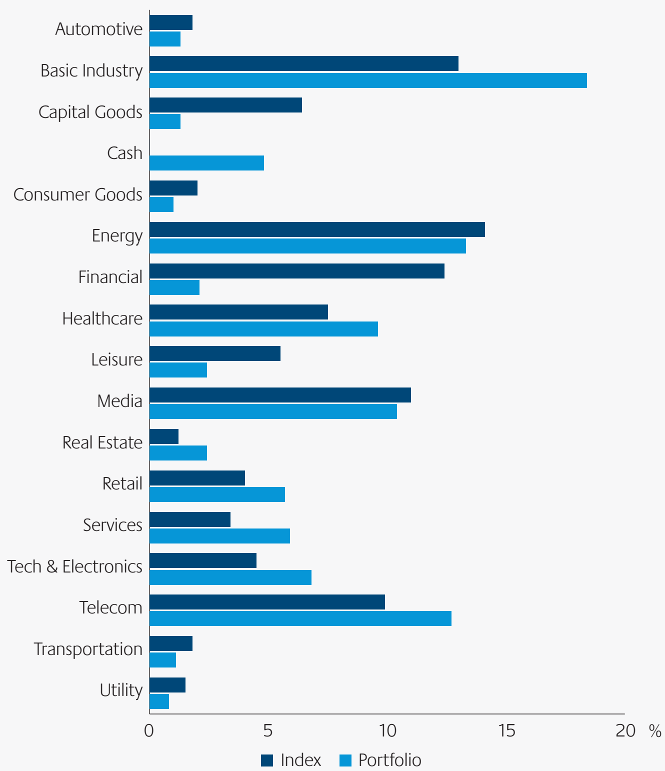
Composite Performance

Short Duration High Yield returned 1.71% for Q3'17, which outperformed the BofA Merrill Lynch 1-5 yr BB-B US Cash Pay High Yield Constrained Index by 26bps. Since inception on May 1st, 2017, Short Duration High Yield has outperformed its Index by 12bps.

Characteristics

	Short Duration	Index
Yield to Worst	4.29%	3.98%
Spread to Worst	280	249
Duration to Worst	1.9	1.94
# of Issuers	81	368
Avg. Rating	B1/BB-	BB3

Sector weightings: Portfolio, Benchmark



Breakdown by Rating

Security Description	Market Value %
A+ (Cash)	4.8%
BBB-	1.4%
BB+	13.7%
BB	13.9%
BB-	22.4%
B+	19.1%
B	15.0%
B-	8.6%
CCC+	1.0%

Breakdown by Country

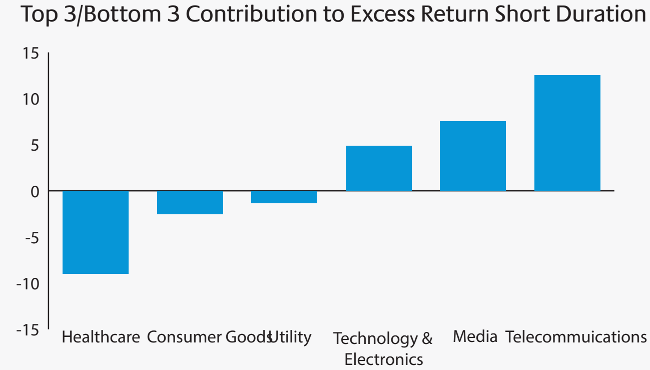
Security Description	Market Value %
United States	91.1%
Canada	3.8%
France	2.0%
United Kingdom	1.3%
Ireland	1.0%
Australia	0.8%

Top 10 Issuers

Security Description	Market Value %
Taylor Morrison Home Corp	2.7%
Intelsat SA	2.5%
iStar Inc	2.4%
Qorvo Inc	2.3%
Altice International	2.3%
BlueScope Steel Ltd	2.3%
Frontier Communications Corp	2.2%
Peabody Energy Corp	2.0%
Penske Automotive Group	2.0%
Lamar Advertising Company	1.9%

Sector & Issuer Commentary

Top 3/Bottom 3 Contribution to Excess Return Short Duration



Positive Contributors:

Telecommunications, **Media**, and **Technology** were the sectors that added the most positive alpha during the quarter.

Telecommunications The portfolio benefited from a diverse group of holdings primarily in the Satellite sub-sector. These credits continue to benefit from growing broadband demand and advances in new high-throughput satellite technologies.

Media: Sirius (SIRI) was among a group of diverse credits driving strong performance in the portfolio's Media sector exposure.

Technology: Qorvo Inc (QRVO) was our top performer in the Technology industry, and is one of our highest quality credits due to extremely high asset coverage.

Negative Contributors:

Healthcare, **Consumer** and **Utilities** were the sectors that detracted the most negative alpha during the quarter.

Healthcare: Kindred Healthcare (KND) underperformed due primarily to an unexpected announcement proposing sharp reduction in government reimbursement rates that could negatively impact the company's Home Health business unit. More broadly across Healthcare we benefited by rotating out of our levered hospital exposure while increasing our position in pharmaceutical credits where we identified a few attractive opportunities in secured debt and near term maturities.

Consumer: Dean Foods (DF) underperformed as lower milk prices resulted in weak quarterly operating results, and full-year outlook. The company already faced the uncertainty of lost sales volumes after Wal-Mart completes its plan to build their own milk plant. We have exited our position in the name.

Utilities: The portfolio was underweight the Utility sector which proved a drag to performance.

Defensive High Yield

This is a defensive strategy that focuses on the higher quality segment of the High Yield market with more limited interest rate exposure. The benchmark is the Bank of America Merrill Lynch BB-B US High Yield Constrained Index. The excess return target is 100bp.

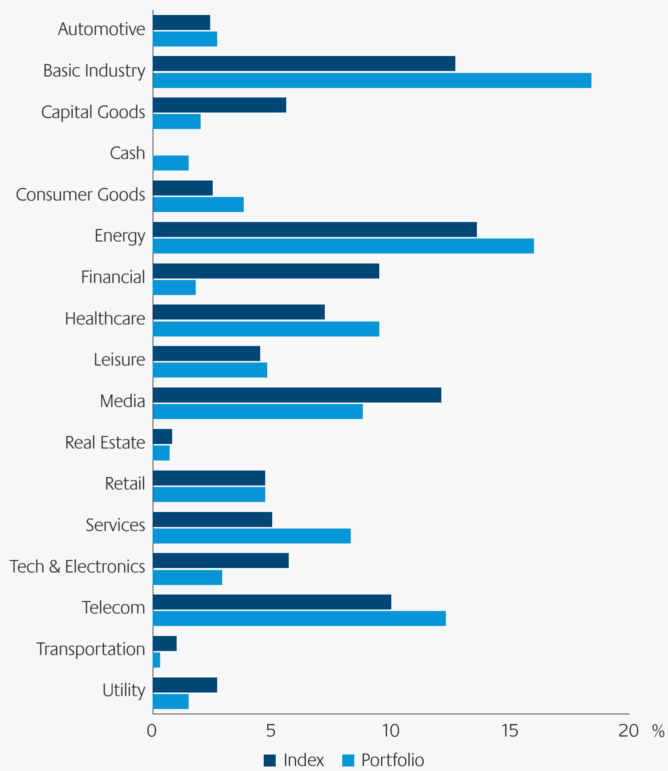
Composite Performance

Defensive High Yield returned 2.01% for Q3'17, which outperformed the BofA Merrill Lynch BB-B US High Yield Constrained Index by 7bps. Since inception on May 1st, 2017, Defensive High Yield has outperformed its Index by 25bps.

Characteristics

	Defensive	Index
Yield to Worst	4.99%	4.63%
Spread to Worst	324	285
Duration to Worst	3.32	3.62
# of Issuers	146	676
Avg. Rating	B1/BB-	BB3

Sector weightings: Portfolio, Benchmark



Securities discussed are the largest positive and negative contributors for the specific sectors.

Breakdown by Rating

Security Description	Market Value %
A+ (Cash)	1.5%
BBB-	2.0%
BB+	9.0%
BB	12.9%
BB-	24.0%
B+	23.1%
B	16.0%
B-	10.1%
CCC+	1.3%

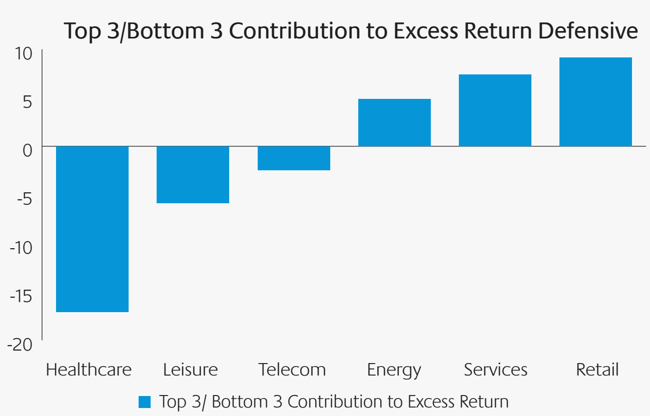
Breakdown by Country

Security Description	Market Value %
United States	87.9%
Canada	6.1%
France	5.1%
United Kingdom	0.7%
Ireland	0.1%
Australia	0.1%

Top 10 Issuers

Security Description	Market Value %
Altice International	2.6%
Intelsat SA	2.2%
Donnelley Financial Solutions Inc	2.1%
Peabody Energy Corp	2.0%
Frontier Communications Corp	1.9%
Rite Aid Corp	1.8%
Valeant Pharmaceuticals International Inc	1.7%
Cincinnati Bell Inc	1.6%
Endo International PLC	1.6%
Penske Automotive Group	1.6%

Sector & Issuer Commentary



Positive Contributors:

Retail, **Services**, and **Energy** were the sectors that added the most positive alpha during the quarter.

Retail: **Penske Automotive (PAG)** is a car dealer that we particularly liked given its strong market position, low leverage, and high asset coverage. Overall, the portfolio benefited from being underweight retail.

Services: **Herc Rentals (HERCRE)** also experienced tightening bond spreads due to strong operating performance from the equipment rental company.

Energy: **Oasis Petroleum (OAS)** performed well amongst a group of portfolio holdings in the E&P Sector that made a meaningful positive contribution to performance. While performance benefited from higher oil prices in the third quarter, we have continued to focus on higher quality E&P issuers, estimated to present high levels of asset value coverage that would withstand potential volatility of commodity prices.

Negative Contributors:

Healthcare, **Leisure**, and **Financials** were the sectors that detracted the most negative alpha during the quarter.

Healthcare: **Kindred Healthcare (KND)** underperformed due primarily to an unexpected announcement proposing sharp reduction in government reimbursement rates that could negatively impact the company's Home Health business unit. More broadly across Healthcare we benefited by rotating out of our levered hospital exposure while increasing our position in pharmaceutical credits where we identified a few attractive opportunities in secured debt and near term maturities.

Leisure: **AMC Entertainment (AMC)** dragged down the Leisure sector. While poor box-office results are impacting the entire industry, AMC's results were magnified by its integration of recently acquired assets that temporarily increased fixed costs. Management communicated a plan to reduce operating costs going forward and has already completed several asset sales earmarked to reduce leverage. The position has since rebounded sharply.

Financials: The portfolio was underweight the Financial sector which proved a drag to performance.

Securities discussed are the largest positive and negative contributors for the specific sectors.

Analysis: High Yield Market Internals

The Opportunity Set is Narrow...

Currently, the most challenging high yield market dynamic is the narrow opportunity set of high yield securities that we find attractive, based on our disciplined investment process.

A brief reminder of recent high yield market valuation milestones provides a backdrop to this discussion:

Our primary high yield benchmark is the BAML U.S. High Yield Constrained Index's (HUC0).

The HUC0 Index benchmark last peaked almost 3 1/2 years ago, on **June 23, 2014** at a spread-to-worst (STW) of 354 basis points over its comparable U.S. Treasury bond.

Over the following nearly 20-month period the market index finally bottomed on **February 11, 2016** at +888 basis points over Treasuries, primarily driven by severe declines in commodity prices (energy and metals, in particular).

As of this writing, 20-months subsequent to the 2016 market low, the HUCO Index closed +356 bps over on **October 20, 2017**.

Our definition of "**opportunity set**" is the sum total of all credits, at any point in time, that "fit" our investment process: 1. meeting our minimum margin-of-safety requirements, and 2. over-compensating, in yield and spread, for our estimates of their default risks.

And as already pointed out, the current high yield market opportunity set is as narrow as we have ever seen in our high yield market careers.

Therefore, the implementation of our investment process currently reflects a portfolio positioning driven, in part by this unusually narrow opportunity set.

One of the most transparent indications of this narrowed opportunity set is observed in the number of bonds in the HUCO Index currently offering a spread-to-worst, rate premium **less than 200 basis points** above a comparable U.S. Treasury bond:

BAML US HY Constrained	Q3-17 End	Q3-17 Start	Year-End 2016	Near 2016 Bottom	Near Previous Peak	Near Previous Peak
% issues priced <+200 STW	28.8%	22.7%	11.7%	1.0%	12.0%	41.9%
# issues priced <+200 STW	539	428	229	23	271	762
# issues in HUCO Index	1873	1888	1949	2248	2255	1819
Yield to Worst	5.47	5.69	6.17	9.20	5.01	7.47
Spread to Worst	368	392	439	780	372	258
US Treasury Yield	1.79	1.77	1.78	1.40	1.29	4.89
Avg Price	$101.77	$101.31	$99.59	$87.07	$105.65	$101.46
LIBOR 3-Month	1.33	1.30	1.00	0.61	0.23	5.36

Source: BofAML Indices and Bloomberg as of 9/30/17.

In the table above:

- At the **beginning of 2017**, a noticeable **11.7% of issues** in the BAML U.S. High Yield Constrained Index (HUCO) already presented STW's <200 basis points.

  Note: In our view, 200 bps of excess spread over a comparable risk-free Treasury note is a particularly noteworthy spread; because our investment process considers +200 bps as the **minimum spread** required in order to invest in even the safest non-investment grade bonds (unless we view it as a "special situation" e.g. near term tender, or upgrade to an IG-rating).
- By the end of September (last month), **28.8% of issues** were priced to a STW <200 bps: a 17% increase YTD, and 6% higher since the beginning of the third quarter
- Looking back to **the early 2016 low**, it is noteworthy that only **1% of issues** presented a STW <200 bps.
- Finally at the **market peak of May 2007**, an eye-opening **42% of issues** offered a STW <200 bps. **However**, in that market environment CASH was a viable alternative to "mispriced" high yield: with the 3-month T-bill offering a 4.73% coupon equivalent yield vs. the BB-rated, sub-sector of HUC0 offering a 6.77% YTW, +185 STW. "Those were the days."

A strength of our investment process is that it has always been able to construct fully diversified high yield portfolios that "fit" our process AND over-compensate for their estimated default risk. In markets anywhere near "fair value" the process steers portfolios to the appropriate portfolio risk composition for that particular market environment.

At an extreme market peak, way back in **May 2007**, it was possible to "lay in the weeds" by holding meaningful cash balances; and with 3-month LIBOR at 5.36%, bank debt was another solid alternative (in a day when bank debt had restrictive, creditor friendly protective covenants).

In **June 2014**, the investment process would have led to a model portfolio that was **unusually diversified**, with a higher than normal issuer count. In other words, the opportunity set identified by the investment process would have identified 300+ issuers that "fit" the process AND overcompensated for estimated default risk.

At the **end of Q3 2017**, given we face perhaps the **narrowest opportunity set** in our high yield market careers, our investment process guides us to optimal composite portfolios with issuer counts towards the lower-end of the ranges that typically represents full diversification.

In our opinion, if our current AUM was anywhere near the size of previous pools of high yield assets we have managed, the combination of current market liquidity **and** the significantly narrowed opportunity set would force us “off model.” In order to be fully invested, portfolios would be forced to own a significantly higher issuer count than that of our current optimal composite portfolios (which maximizes the default adjusted, yield and spread of fully diversified portfolios).

Since we never intentionally violate our minimum margin-of-safety requirements, the necessity of significantly higher issuer counts would require us to own a meaningful number of credits that **do not** over-compensate for their individual default risks, based on our investment process. In other words:

We would be forced to own a meaningful number of high yield issues that are currently fully-valued, or somewhat over-valued relative to our estimates of their individual default risks; and none of us have ever been forced into that position during our high yield careers.

Finally, among portfolio managers that currently find it necessary to own higher-quality high yield bonds at the wrong prices, **some** are likely to be inclined to own average-quality, and lower-quality bonds at the wrong prices. Worse yet, are the high yield firms that lack an investment process that effectively manages “price” versus “risk” in the first place. In our view, those managers are now (even more than usual) positioned for particularly “unfortunate” performance in any meaningful market correction. Therefore, more than ever, in our opinion: Buyer Beware.

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