

# First State Investments High Yield

Q3 2018 | Co-Portfolio Managers: Matt Philo & Jason Epstein

**“There are two kinds of forecasters: those who don’t know, and those who don’t know they don’t know.”**

– John Kenneth Galbraith

## Thoughts on the Market

In general, global corporate bonds posted positive total returns during the third quarter of 2018, as reflected in [Table 1](#), below: **“3Q18” & “YTD 30-Sep”**.

However, as of this writing, the first two weeks of the fourth quarter have experienced notable financial market volatility, also reflected in [Table 1](#), below: **“MTD 12-Oct” & “YTD 12-Oct”**.

**Table 1: Returns of Various Assets**

Asset Class	1H18	3Q18	YTD 30-Sep	MTD 12-Oct	YTD 12-Oct
S&P 500	+2.65%	+7.71%	+10.56%	-6.31%	+3.58%
<b>US High Yield Corp Bonds</b>	<b>+0.08%</b>	<b>+2.44%</b>	<b>+2.52%</b>	<b>-0.92%</b>	<b>+1.58%</b>
Leveraged Loans	+2.33%	+2.00%	+4.38%	+0.10%	+4.48%
10-Year US Treasury	-2.68%	-1.10%	-3.75%	-0.60%	-4.33%
Investment Grade Corp	-3.12%	+0.96%	-2.19%	-0.70%	-2.88%
Euro High Yield Corps	-1.68%	+1.67%	-0.04%	-0.44%	-0.48%
EM High Yield Corps	-3.68%	+1.59%	-2.16%	-0.06%	-2.21%
Emerging Market Stocks	-6.64%	-1.00%	-7.57%	-8.85%	-15.75%
<b>US High Yield by Rating</b>					
BB US High Yield Corps	-1.78%	+2.31%	+0.49%	-1.02%	-0.54%
B US High Yield Corps	+1.02%	+2.32%	+3.36%	-0.82%	+2.52%
CCC US High Yield Corps	+3.15%	+2.80%	+6.03%	-0.91%	+5.07%

Source: JP Morgan, ICE BAML

**3Q’18** U.S. equities hit new all-time highs during the 3<sup>rd</sup> quarter, despite a further rise in U.S. Treasury yields:

- 10-Year UST above 3% for the first time since Dec-2013
- 5-Year UST yield above 3%, just 3 days into October, for the first time since 2008.

U.S. High Yield posted its strongest total return since 1Q 2017, edging out that of U.S. Leveraged Loans.

Despite higher UST rates, U.S. Investment Grade corporate bonds were also total return positive.

The STW of the U.S. HY market, as represented by the ICE BofAML US High Yield Constrained Index (HUCO), declined to +327 bps over its comparable UST bond on September 25<sup>th</sup>. Notably, the last time that Index traded as tight as +327 was in July 2007; an admittedly dubious distinction, if not unique amongst fixed income classes:

**Table 2: STW Lows of Various Asset Classes**

Asset Class	Recent STW low	Date	Previous lower STW	Date	Bloomberg Ticker
US High Yield Corp Bonds	+327	Sep-18	+314	Jul-07	HUCO
Investment Grade Corp	+88	Feb-18	+86	Feb-07	COA0
BBB-rated Corp	+141	Jan-18	+137	Aug-07	COA4
Euro High Yield Corps	+235	Nov-17	+231	Jul-07	HE00
EM High Yield Corps	+313	Jan-18	+310	Jul-07	EMHB
EM Liquid Corp Plus	+201	Jan-18	+198	Jul-07	EMCL
<b>US High Yield by Rating</b>					
BB US High Yield Corps	+203	Jan-18	+202	Jun-07	HUC1
B US High Yield Corps	+337	Jan-18	+323	Jul-07	HUC2
CCC US High Yield Corps	+628	May-14	+615	Jul-07	HUC3

As evidenced in [Table 2](#), above, the Broad High Yield Index was late to the party in achieving 10+ year STW tights. All the other asset classes in the table achieved that status earlier in 2018; except EU High Yield (Nov-2017) and CCC U.S. HY (back in May-2014). In the case of CCC-HY we believe the earlier milestone is due to survivor bias: many “inevitable” bankruptcies which represented some of the most distressed names from the overall HY Index have filed C11 and dropped out of the index.

During the third quarter, only Emerging Market stocks experienced continued weakness. With the benefit of hindsight, as of this writing, the continued weakness in UST bonds and EM equities were both foreshadowing a return of downside financial market volatility.

In [Table 1](#), above, the widespread weakness across asset classes in the first two weeks of October is readily apparent. Most notably, EM Equities continued their rapid decline, down nearly 16% YTD. UST rates also increased somewhat higher and U.S. stocks gave back most of their third quarter gains.

As usual, High Yield continues to be the typical market pundit's favorite cautionary target. As always, we take comfort in this simpleton view of the credit markets. We continue to like the relative value of our team's high yield composite portfolios better than all other fixed income alternatives.

As we observed last quarter, we'll be worried should we ever start hearing our real-world based views echo back to us: *"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."*

## High Yield Market Commentary

As already noted, the STW of the U.S. HY market, as represented by the ICE BofAML US High Yield Constrained Index (HUC0) declined to +327 bps over its comparable UST bond on September 25<sup>th</sup>; the tightest STW since mid-July 2017. Most other credit asset classes achieved 10+ year STW tights earlier in 2018 (see Table 2).

The High Yield market corrected somewhat noticeably in just the first two weeks of October; in sympathy with U.S. stock declines which is often its knee-jerk reaction. The STW of the U.S. HY market, as represented by the HUC0 Index increased 25 basis points during the two week period; and with modestly higher UST rates, the YTW increased 32 bps to 6.61%.

During the third quarter, the strongest performing industry sectors within the overall high yield market were Healthcare, Cable & Telecom. Within those strong sectors, the pharmaceutical & satellite credits were positive standouts. Weak industry sectors included Housing & Retail.

During the first two weeks of October, the only noticeable sector standout on the downside was Automotive; driven in large part by reduced production expectations for China.

Net-net, U.S. High Yield continues to benefit from its:

- Current income advantage (relative to most fixed income alternatives)
- Relatively short duration (sensitivity to interest rates)
- Greater dependence on the N. American economy (than IG or non-U.S. alternatives)
- Relatively attractive supply-demand dynamics (slow-to-no-growth market size)

One temporary vulnerability for high yield is passive investment strategies, represented most transparently in HY ETF flows. As highlighted by J.P. Morgan's strategist Peter Acciavatti: *"High-yield bond funds reported an outflow totaling -\$4.9BN for the week ending October 10<sup>th</sup> (2.4% AUM), the fourth largest weekly outflow on record for the asset class... HY ETFs reported outflows totaling -\$4.2bn and Actively Managed HY funds reported outflows totaling -\$719mn. In fact, the past week's withdrawal for the ETFs easily exceeded the prior high in November 2016 (\$3.45bn)."*

Fortunately, passive investing is much less prevalent in high yield than most other asset classes in today's markets. However, in a high yield market where we observe the narrowest "Opportunity Set" ever in our experience, passive high yield strategies are a special kind of "accident waiting to happen." Please see **"Analysis: "Opportunity Set"**, for an update on this critical high yield market dynamic.

U.S. Stocks, more than offset any technical challenges presented by the sell-off in Emerging Market bonds and stocks.

## Portfolio Positioning

The prominent trend across our high yield composite portfolios during the third quarter was our typical contrarian adjustment of portfolio risk levels as dictated by the implementation of our disciplined investment process. In other words, as the quarter's rally was strongest in July, followed by August, the resultant price strength within our portfolio required a steady reduction in overall portfolio risk. While not a dramatic shift, still noticeable, for example, in moving our Broad High Yield Composite yield and spread in-line with the benchmark index, versus its previous premium positioning. In terms of sectors, our Broad, Select & Quality HY composites ended 3Q-18 with a noticeable underweight in Healthcare versus their index benchmarks; having been modest overweight at the end of 2Q-18. Market strength also led to measured reductions in select telecom credits. In contrast, half way into October our investment process is already directing us to reverse the general risk reduction trend, after just two weeks of downside price volatility.

Finally, our "macro" conjecture in honor of John Kenneth Galbraith. Our investment process manages credit risk primarily reliant on our fundamental, bottom-up investment process. However, portfolio risks involve top-down risk reviews that can include views regarding asset flow, trading liquidity and market correlation risks. As a result, we observe the long-running financial asset purchases of Global Central Banks ("QE") with interest. The current "conventional wisdom" in investment commentary is that of an IMPENDING shift from "QE" to "QT" (quantitative easing to quantitative tightening). We continue to view the likelihood of meaningful, net "QT" as very unlikely, to somewhat impossible.

The more realistic worry, in our view is the potential reversal in the "shadow banking" system multiplier effect that has made "QE" so powerful in the first place. In short, we expect the unregulated shadow banking players (e.g. hedge funds & derivative markets) resulted in final gross asset purchases many times greater than the already massive Central Bank asset purchases. This undefinable, nontransparent multiplier effect has the potential to create significant market disruptions: e.g. in any disorderly, fear-driven attempt to unwind the massive leveraged investments we view as inherent in the shadow banking system.

**However, we've been wrong before!**

## Composite Performance Summary

## High Yield Composites - Annualized

September 30, 2018								
	3Q-2018	2Q-2018	1Q-2018	YTD-2018	1 year	Since Inception May 1, 2017	AUM (\$m)	Inception Date
<b>Broad High Yield</b>	<b>2.39%</b>	<b>0.90%</b>	<b>-0.17%</b>	<b>3.14%</b>	<b>3.95%</b>	<b>5.18%</b>	<b>197.1</b>	<b>30/04/2017</b>
ICE BofAML US High Yield Constrained Index	2.44%	1.00%	-0.91%	2.52%	2.94%	4.26%		
Excess (a)	-0.05%	-0.10%	+0.74%	+0.62%	+1.00%	+0.92%		
<b>Select High Yield</b>	<b>2.21%</b>	<b>1.30%</b>	<b>0.06%</b>	<b>3.59%</b>	<b>4.45%</b>	<b>5.48%</b>	<b>67.5</b>	<b>30/04/2017</b>
ICE BofAML US High Yield Constrained Index	2.44%	1.00%	-0.91%	2.52%	2.94%	4.26%		
Excess (a)	-0.23%	+0.30%	+0.97%	+1.07%	+1.50%	+1.22%		
<b>Quality High Yield</b>	<b>2.49%</b>	<b>0.71%</b>	<b>-0.27%</b>	<b>2.94%</b>	<b>3.72%</b>	<b>5.04%</b>	<b>129.5</b>	<b>30/04/2017</b>
ICE BofAML BB-B US High Yield Constrained Index	2.38%	0.65%	-1.11%	1.90%	2.29%	3.70%		
Excess (a)	+0.11%	+0.06%	+0.84%	+1.04%	+1.43%	+1.34%		
<b>Short Duration High Yield</b>	<b>1.98%</b>	<b>0.95%</b>	<b>0.39%</b>	<b>3.35%</b>	<b>3.75%</b>	<b>4.36%</b>	<b>47.6</b>	<b>30/04/2017</b>
ICE BofAML 1-5 Yr BB-B US Cash Pay HY Constrained Index	2.08%	1.14%	0.15%	3.39%	3.73%	4.26%		
Excess (a)	-0.10%	-0.19%	+0.24%	-0.04%	+0.02%	+0.10%		
<b>Defensive High Yield</b>	<b>2.35%</b>	<b>0.78%</b>	<b>-0.11%</b>	<b>3.03%</b>	<b>3.74%</b>	<b>4.92%</b>	<b>177.2</b>	<b>30/04/2017</b>
ICE BofAML BB-B US High Yield Constrained Index	2.38%	0.65%	-1.11%	1.90%	2.29%	3.70%		
Excess (a)	-0.02%	+0.12%	+1.00%	+1.13%	+1.45%	+1.22%		

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%.

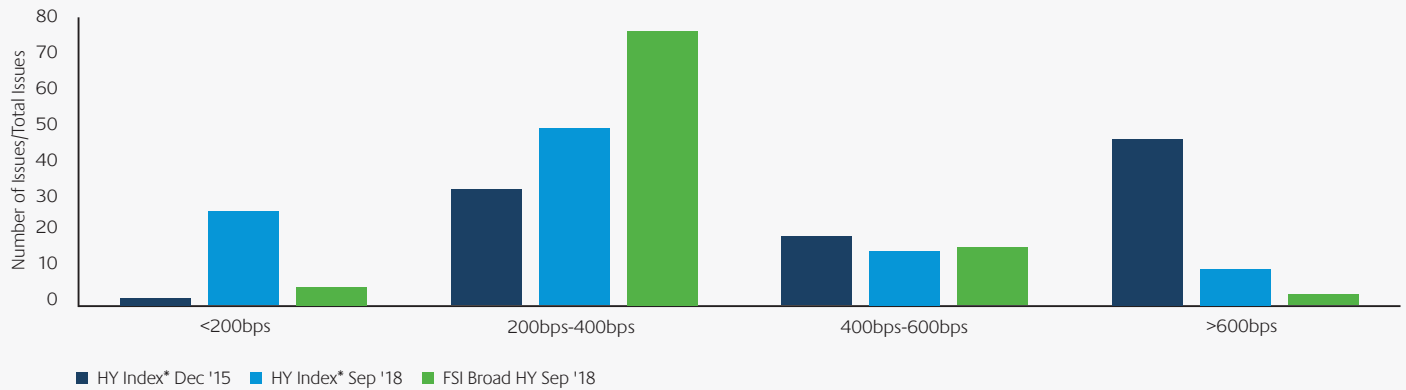
The assets within the FSI Short Duration High Yield Composite and FSI Quality High Yield Composite have been combined to create the FSI Defensive High Yield Composite. The assets within the FSI Select High Yield Composite and the FSI Quality High Yield Composite have been combined to create the FSI Broad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

## Analysis: “Opportunity Set”

The most challenging high yield market dynamic continues to be the narrow opportunity set of high yield securities that we find attractive, based on our disciplined investment process. We can’t emphasize enough the severe challenge this dynamic presents to high yield managers with \$10 billion, \$20 billion or more in high yield AUM.

Even more importantly, this market environment is one where managers that “closet-index” or lack an effective and disciplined investment process are heading towards a reckoning that will prove painful to disastrous for their investors. “Buyer Beware.”

Percentage (%) of Total Issues in Various Spread-to-Worst Ranges (“Buckets”)



\*ICE BofAML US High Yield Master II

Percentage (%) of Total Issues in various Spread-to-Worst Ranges (“Buckets”)				
HY Index* “Spread Migration”		“Spread Buckets” (bps)		
Sept 30, 2018 versus Dec 31, 2015	600+	600 to 400	400 to 200	<200
HY Index* Dec '15	46%	19%	32%	2%
HY Index* Sep '18	10%	15%	49%	26%
“Spread Migration” Since Dec'15	-36%	-5%	17%	24%
FSI Broad HY vs. HY Index* Sept'18		“Spread Buckets” (bps)		
September 30, 2018	600+	600 to 400	400 to 200	<200
HY Index* Sept-2018	10%	15%	49%	26%
FSI Broad HY Sept-2018	3%	16%	76%	5%
“Underweight the Tails” Sept'18	-7%	1%	27%	-21%
*ICE BofAML US High Yield Index				
Source: ICE BofAML Bond Indices, Aladdin by BlackRock				

### HY Index\* “Spread Migration”

Just 10% of high yield credits offered a STW > +600 bps at the end of 3Q '18, versus 46% year-end 2015, (-36%).

Credits with STW < +200 (below our investment process minimum) are 26% of HY issues, (+24% versus Dec-15).

The narrow “opportunity set” is apparent by 75% of credits offering STWs < +400 bps (versus 34% Dec-15).

### FSI Broad High Yield versus HY Index\*

Our Broad High Yield portfolio ended 3Q '18 with a YTW & STW in-line with the overall high yield market.

It is interesting to observe the underweights in the “spread bucket” tails of > 600+ bps & < 200 bps (-7% & -21%). The offset to those underweights is primarily a 27% overweight in credits with STWs +200-400 bps.

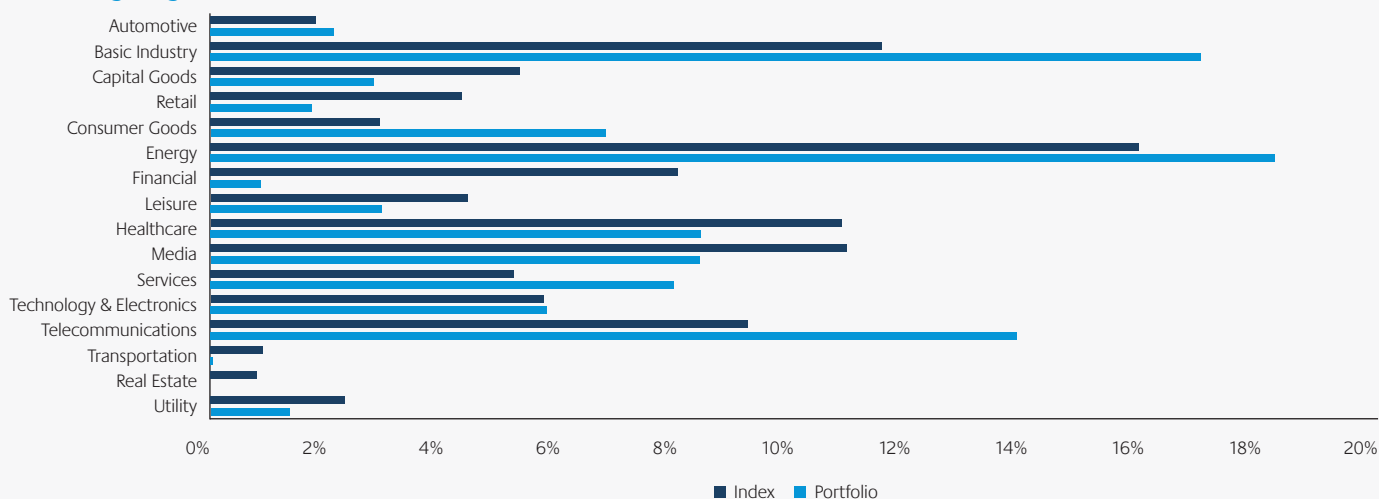
This positioning is what we would expect from our disciplined investment process in a high yield market where the average credit is near, or rich relative to fair value.

# Broad High Yield

## Characteristics

	Broad	Index
Yield to Worst	6.23%	6.22%
Spread to Worst (bps)	332	333
Duration to Worst (years)	3.95	3.92
# of Issuers	145	
Avg. Rating	B1	

## Sector weightings: Portfolio, Benchmark



## Breakdown by Rating

Rating	Market Value %
BBB-	3.28%
BB+	5.31%
BB	16.01%
BB-	24.35%
B+	13.51%
B	15.86%
B-	10.37%
CCC+	6.53%
CCC	1.17%
Other	1.64%

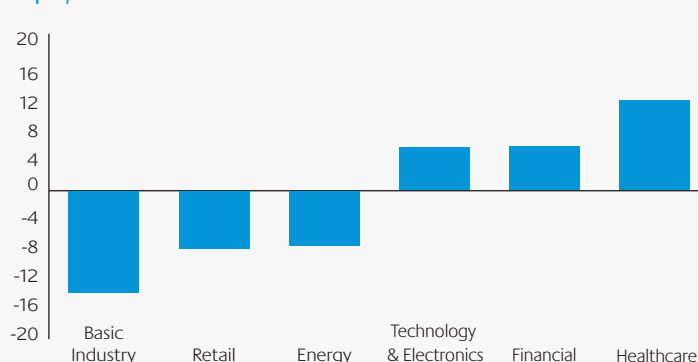
## Breakdown by Country

Country	Risk Contribution %
United States	92.40%
Canada	2.80%
France	1.77%
Australia	0.74%
Ireland	0.23%
United Kingdom	0.73%
United Arab Emirates	0.51%
Israel	0.64%
Netherlands	0.22%
Other	0.00%

## Top 10 Issuers

Issuer	Market Value %
Frontier Communications Corp	2.82%
Sprint Corp	2.53%
Asurion	2.40%
Donnelley Financial	2.34%
Bausch Health Companies Inc	2.31%
CSC Holdings	1.97%
Pilgrim's Pride Corporation	1.85%
Horizon Pharma PLC	1.82%
California Resources Corp	1.72%
Ply Gem Holdings	1.68%

## Top 3/Bottom 3 Contribution to Excess Return



## Sector & Issuer

### Positive Contributors (top three):

**Sprint Corp (S):** Sprint bonds have traded well as the prospects of regulatory approvals to merge with T-Mobile seem to be improving, and supportive of potential merger completion in 1H'19. A merger with T-Mobile should be a significant credit positive due to improved pro forma credit metrics and longer-term competitiveness. On a stand-alone basis, Sprint continues to expect to begin offering commercial 5G services and handsets in 1H'19. In the short-term operations are benefiting from an economic tailwind. Medium-term, fiscal 2019 should be free cash flow breakeven despite the large capex required to complete the 5G buildout. Longer-term the company's spectrum position is solid and controlling shareholder, Softbank has been financially supportive.

**Endo International (ENDP):** Endo bonds outperformed on the strength of its Q2'18 earnings. Highlights include the specialty and sterile injectables units, which helped to offset continued weakness in the company's generic division. As well, Xiaflex continues to stand out as a bright spot in the company's pipeline, as its additional use against cellulite may be approved by 2019. Also, news came out in the quarter that was supportive of the durability of the company's Vasostrict product through 2021/2022. Equity investors responded positively as well, as Endo's stock almost doubled in the quarter, providing meaningful benefit to its credit story.

**Bausch Health (BHCCN):** Bausch Health is the new name of Valeant Pharmaceutical, effective July 2018, signaling a fresh start for the company by leveraging the strength of its Bausch & Lomb global brand and highlighting the company's more consumer-oriented business lines. Bausch Health bonds continued their strong performance from Q2'18 through the third quarter. Performance was driven in part by better than expected Q2'18 earnings and slight improvement to full-year guidance. As well, the Company mitigated one of its key risks, settling a lawsuit with TEVA with regards to the generic entry to Xifaxan. Given the importance of Xifaxan to Bausch's GI business this news was received well, with the stock up more than 20% in September, providing meaningful benefit to its credit story.

### Negative Contributors (bottom three):

**Sanchez Energy (SN):** Sanchez surprised the market to the downside with poor results, compounded with the announcement of the hiring of a consultant to help fix some of operational issues. The production issues seem to be a continuation of last quarter and focused on their most recently acquired asset, Comanche, which is suffering from high production rate declines because of poor landing zones and tight spacing. Combining this with a complicated capital structure and a lack of asset sales has led to the bonds being pressured. Shortly after the results, we exited our position in the name.

**Titan Acquisition (HUSKYI):** Titan Acquisition, also known as Husky IMS International, was a new issuer to the market in the second quarter of 2018 after Platinum Equity bought the firm for 10x EBITDA. The company reported continued soft results in Q2'18 results which pressured bond prices. Shortly after the quarterly results, we exited our position in the name.

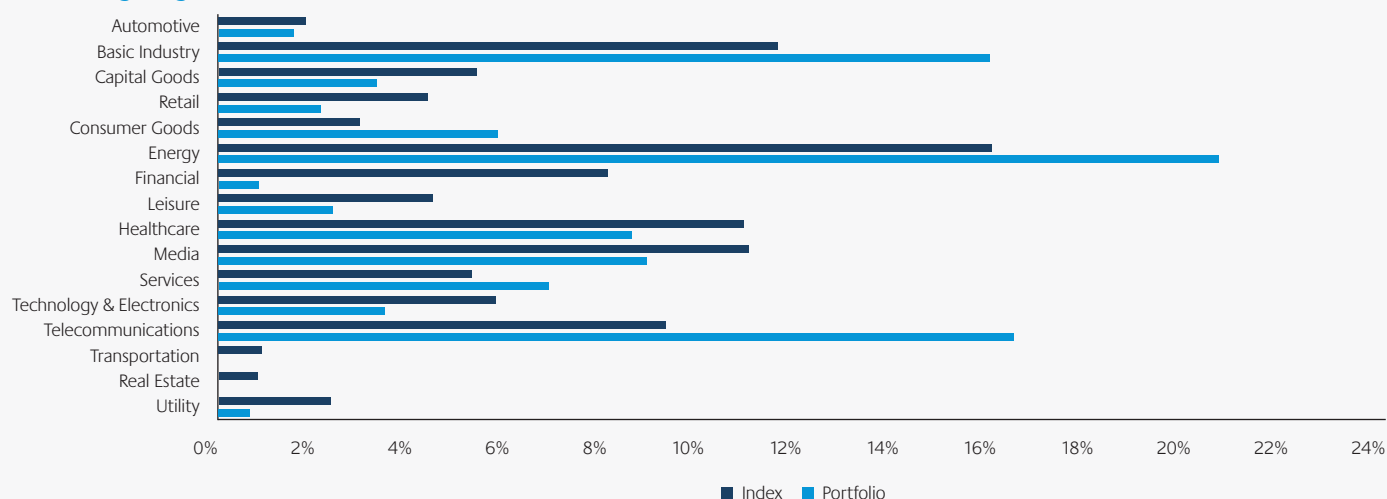
**Rite Aid (RAD):** Rite Aid had a series of negative events in the third quarter. First, they lower FY19 earnings guidance, highlighting the challenging operation environment there in. Second, their shareholders rejected the proposed merger with Albertsons, which would have deleveraged the entity due to Albertson's less leveraged capital structure and synergies. Bondholders were clearly putting a high probability on the deal ultimately getting done, and the bonds fell noticeably when the transaction fell apart. We continue to like RAD bonds standalone, and see a longer term strategy for improved results.

## Select High Yield

### Characteristics

	Select	Index
Yield to Worst*	6.58%	6.22%
Spread to Worst (bps)	367	333
Duration to Worst (years)	3.93	3.92
# of Issuers	101	
Avg. Rating	B2	

### Sector weightings: Portfolio, Benchmark



### Breakdown by Rating

Rating	Market Value %
BBB-	2.50%
BB+	2.92%
BB	11.08%
BB-	19.99%
B+	9.96%
B	14.39%
B-	13.95%
CCC+	16.78%
CCC	3.41%
Other	1.73%

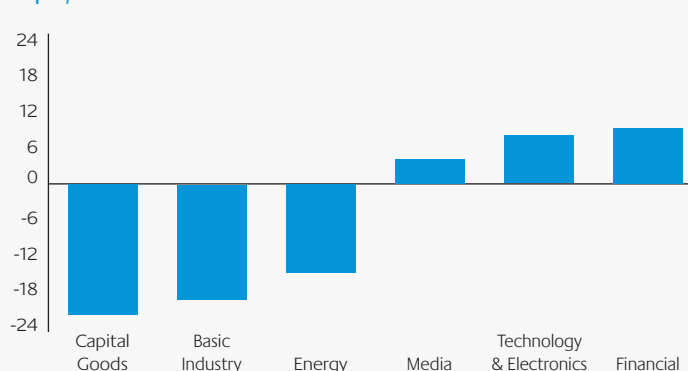
### Breakdown by Country

Country	Risk Contribution %
United States	93.50%
Canada	2.24%
France	1.53%
Australia	0.70%
Ireland	0.67%
United Kingdom	0.58%
United Arab Emirates	0.40%
Israel	0.37%
Other	0.00%

### Top 10 Issuers

Issuer	Market Value %
Ply Gem Holdings	3.71%
Iridium Communications Inc	3.41%
Frontier Communications Corp	3.17%
Sprint Corp	2.60%
Bausch Health Companies Inc	2.48%
California Resources Corp	2.31%
Clear Channel International	2.24%
Donnelley Financial Solutions Inc	2.20%
Denbury Resources Inc.	2.15%
Horizon Pharma PLC	2.00%

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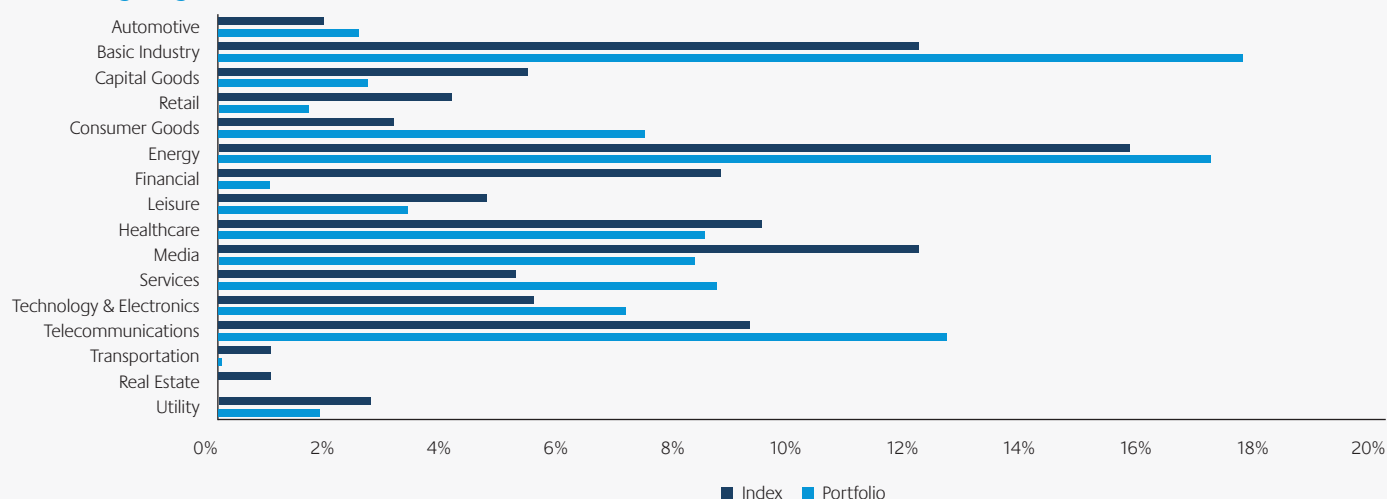


# Quality High Yield

## Characteristics

	Quality	Index
Yield to Worst*	6.05%	5.74%
Spread to Worst (bps)	313	285
Duration to Worst (years)	3.96	4.03
# of Issuers	137	
Avg. Rating	B1	

## Sector weightings: Portfolio, Benchmark



## Breakdown by Rating

Rating	Market Value %
BBB-	3.68%
BB+	6.56%
BB	18.57%
BB-	26.62%
B+	15.36%
B	16.62%
B-	8.50%
CCC+	1.18%
Other	1.59%

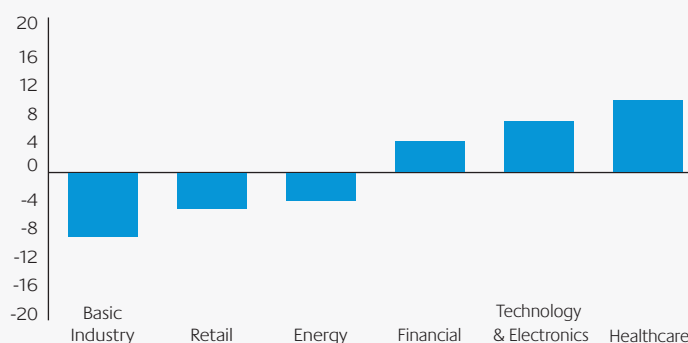
## Breakdown by Country

Country	Risk Contribution %
United States	91.76%
Canada	3.08%
France	1.90%
Australia	0.81%
United Kingdom	0.78%
United Arab Emirates	0.76%
Israel	0.57%
Netherlands	0.34%
Other	0.00%

## Top 10 Issuers

Issuer	Market Value %
Frontier Communications Corp	2.63%
Asurion	2.62%
Sprint Corp	2.49%
Donnelley Financial Solutions Inc	2.42%
Bausch Health Companies Inc	2.23%
CSC Holdings	2.00%
Pilgrim's Pride Corporation	1.84%
Horizon Pharma PLC	1.71%
Hughes Satellite	1.55%
United States Cellular Corp	1.54%

## Top 3/Bottom 3 Contribution to Excess Return



## Sector & Issuer

### Positive Contributors (top three):

**Sprint Corp (S):** Sprint bonds have traded well as the prospects of regulatory approvals to merge with T-Mobile seem to be improving, and supportive of potential merger completion in 1H'19. A merger with T-Mobile should be a significant credit positive due to improved pro forma credit metrics and longer-term competitiveness. On a stand-alone basis, Sprint continues to expect to begin offering commercial 5G services and handsets in 1H'19. In the short-term operations are benefiting from an economic tailwind. Medium-term, fiscal 2019 should be free cash flow breakeven despite the large capex required to complete the 5G buildout. Longer-term the company's spectrum position is solid and controlling shareholder, Softbank has been financially supportive.

**Asurion (ASUCOR):** Asurion term loans, particularly the company's 2<sup>nd</sup> lien loan, performed very strongly during 3Q18. Asurion loans traded very well following the company's recent recapitalization, which resulted in higher coupons and a resetting of call protection, partially offset by higher leverage. Additionally, in August Asurion reported another strong quarterly result, which showcased the strength of the company's business model. While Asurion carries higher leverage than some of our other investments, we are comfortable with the risk given the company's strong free cash flow and asset value, and feel that spread levels on the company's loans more than adequately compensate for Asurion's credit risk.

**CenturyLink (CTL):** Subsidiary level debt at the Qwest Corp and Level 3 Financing issuers outperformed after CenturyLink increased fiscal 2018 guidance for both EBITDA and free cash flow. The company increased guidance when it reported in-line 2Q quarterly results in early August. The market bid for the debt at CTL's best operating asset, Level 3 and its least leveraged subsidiary, Qwest Corp both also outperformed the CenturyLink Holding company debt.

### Negative Contributors (bottom three):

**Rite Aid (RAD):** Rite Aid had a series of negative events in the third quarter. First, they lower FY19 earnings guidance, highlighting the challenging operation environment there in. Second, their shareholders rejected the proposed merger with Albertsons, which would have deleveraged the entity due to Albertson's less leveraged capital structure and synergies. Bondholders were clearly putting a high probability on the deal ultimately getting done, and the bonds fell noticeably when the transaction fell apart. We continue to like RAD bonds standalone, and see a longer term strategy for improved results.

**Chesapeake Energy (CHK):** Chesapeake announced in July 2018 the highly anticipated sale of their Utica assets, continuing the positive deleveraging story that the company has been telling for a couple of years now. Shortly thereafter, they announced a new unsecured bond offering, the proceeds of which would refinance the company's term loan that we own. The term loan was refinanced at a call price lower than the trading price of the term loan, resulting in underperformance for the quarter. However, this trade has turned out to be highly profitable since our purchase.

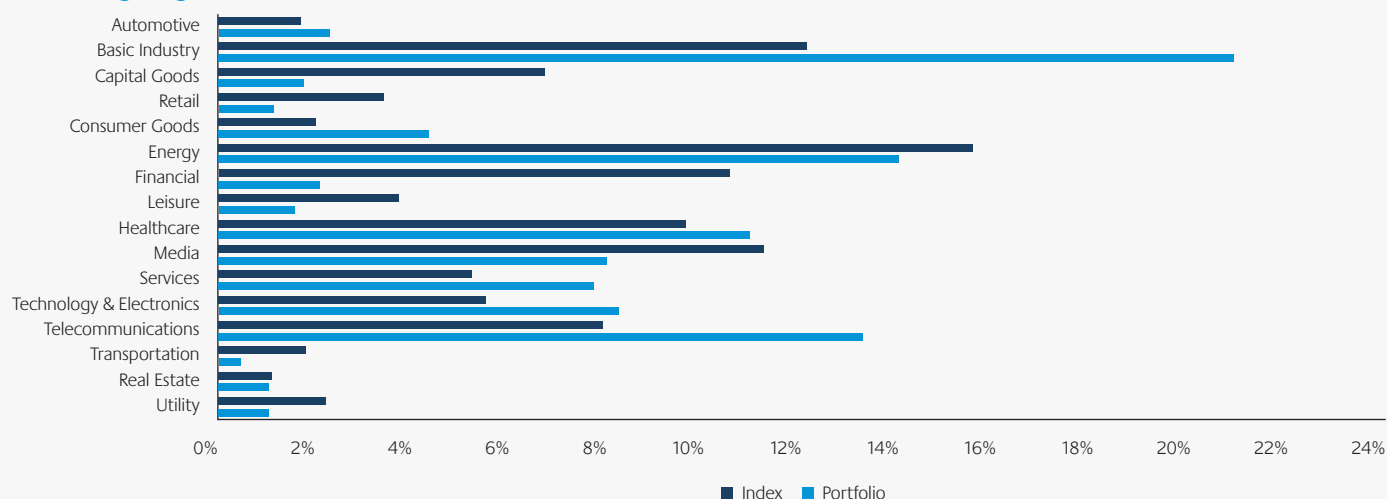
**Venator Materials (VNTR):** Venator bonds underperformed during the quarter owing to a confluence of negative factors including softening industry fundamentals, M&A risk, and operational issues related to rebuilding a damaged plant. While we were comfortable with M&A risk owing to Venator's very strong balance sheet, we are very sensitive to industry fundamentals, given titanium dioxide's notorious cyclicality. When we started receiving data points that suggested that fundamentals may be turning, notably softening prices in Europe and rising raw material prices, we promptly exited our stake in the name. Since then Venator bonds have continued to underperform as analysts continue to reduce their estimates for the company and weigh the impacts of potential M&A and the closure of Venator's damaged plant in Finland. Venator's equity has been absolutely decimated, down 40%+ since the beginning of 3Q18 and down 54% from its IPO, which priced just over one year ago (August 2<sup>nd</sup>, 2018).

# Short Duration High Yield

## Characteristics

	Short Duration	Index
Yield to Worst*	5.19%	5.23%
Spread to Worst (bps)	246	246
Duration to Worst (years)	1.92	2.26
# of Issuers	93	
Avg. Rating	B1	

## Sector weightings: Portfolio, Benchmark



## Breakdown by Rating

Rating	Market Value %
BBB-	2.42%
BB+	10.29%
BB	19.07%
BB-	23.28%
B+	18.02%
B	11.65%
B-	8.41%
CCC+	2.05%
Other	0.00%

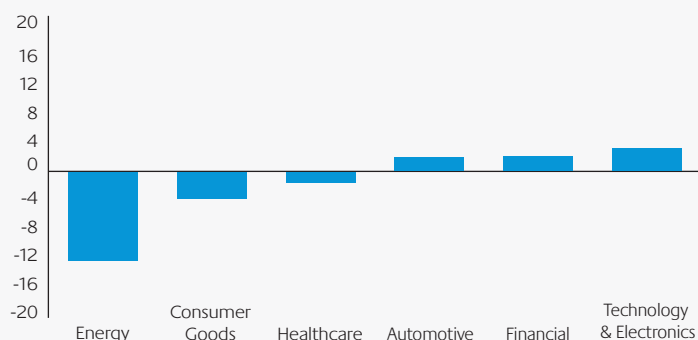
## Breakdown by Country

Country	Risk Contribution %
United States	91.44%
Canada	3.72%
France	1.95%
United Kingdom	1.87%
Ireland	0.49%
Israel	0.37%
Australia	0.17%
Other	0.00%

## Top 10 Issuers

Issuer	Market Value %
Sprint Corp	2.50%
Asurion	2.47%
Frontier Communications Corp	2.41%
Level 3 Communications, Inc	2.27%
First Data Corp	2.24%
Bausch Health Companies Inc	2.21%
Intel Corporation	2.09%
CSC Holdings	2.06%
Antero Resources Corp	1.97%
Oasis Petroleum	1.97%

## Top 3/Bottom 3 Contribution to Excess Return



## Sector & Issuer

### Positive Contributors (top three):

**Sprint Corp (S):** Sprint bonds have traded well as the prospects of regulatory approvals to merge with T-Mobile seem to be improving, and supportive of potential merger completion in 1H'19. A merger with T-Mobile should be a significant credit positive due to improved pro forma credit metrics and longer-term competitiveness. On a stand-alone basis, Sprint continues to expect to begin offering commercial 5G services and handsets in 1H'19. In the short-term operations are benefiting from an economic tailwind. Medium-term, fiscal 2019 should be free cash flow breakeven despite the large capex required to complete the 5G buildout. Longer-term the company's spectrum position is solid and controlling shareholder, Softbank has been financially supportive.

**Avis Budget Group (CAR):** Outperformance was due to the Company's announced intention to refinance our position in the senior notes due 2022 earlier than the market anticipated. The announcement follows solid second quarter earnings and constructive third quarter industry commentary from Avis's major competitor, Hertz.

**Asurion (ASUCOR):** Asurion term loans, particularly the company's 2nd lien loan, performed very strongly during 3Q18. Asurion loans traded very well following the company's recent recapitalization, which resulted in higher coupons and a resetting of call protection, partially offset by higher leverage. Additionally, in August Asurion reported another strong quarterly result, which showcased the strength of the company's business model. While Asurion carries higher leverage than some of our other investments, we are comfortable with the risk given the company's strong free cash flow and asset value, and feel that spread levels on the company's loans more than adequately compensate for Asurion's credit risk.

### Negative Contributors (bottom three):

**Extraction Oil & Gas (EXTOIL):** Extraction Oil & Gas had a weak quarter due to the company's highly concentrated position in the DJ Basin in Colorado. In the upcoming November elections, Colorado has on its ballot something called Proposition 112, which sets new minimum distance requirements for the drilling of new oil & gas wells that would severely hamper oil & gas production in the state. This has affected both the stock and bonds of the company, and while we don't think Prop 112 will pass, we did exit our position in the quarter due to the heightened risk.

**Chesapeake Energy (CHK):** Chesapeake announced in July 2018 the highly anticipated sale of their Utica assets, continuing the positive deleveraging story that the company has been telling for a couple of years now. Shortly thereafter, they announced a new unsecured bond offering, the proceeds of which would refinance the company's term loan that we own. The term loan was refinanced at a call price lower than the trading price of the term loan, resulting in underperformance for the quarter. However, this trade has turned out to be highly profitable since our purchase.

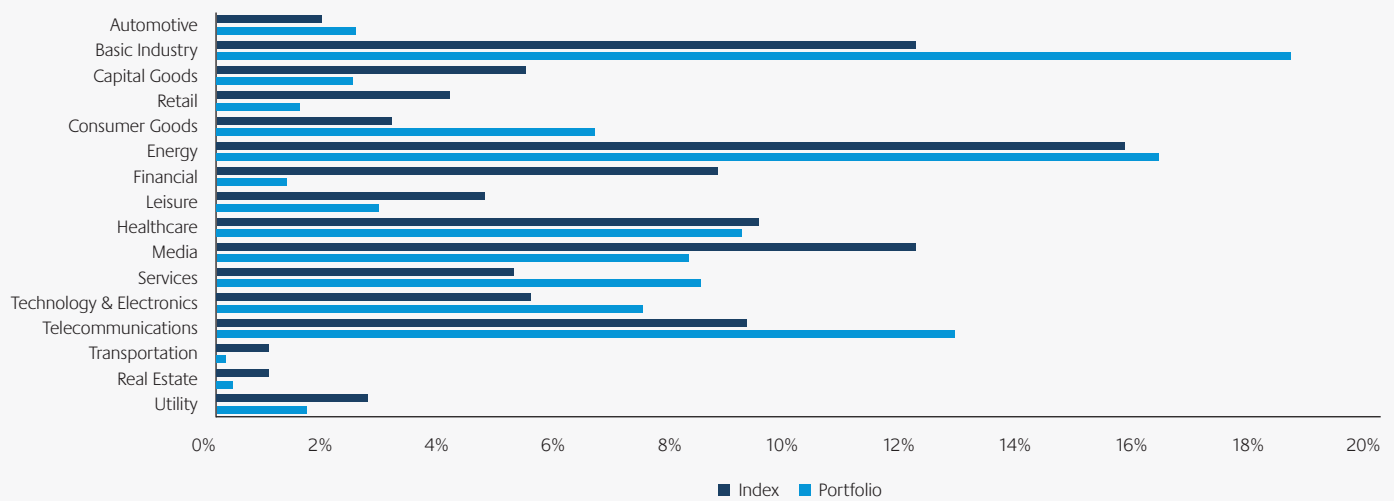
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# Defensive High Yield

## Characteristics

	Defensive	Index
Yield to Worst*	5.82%	5.74%
Spread to Worst (bps)	295	285
Duration to Worst (years)	3.41	4.03
# of Issuers	153	
Avg. Rating	B1	

## Sector weightings: Portfolio, Benchmark



## Breakdown by Rating

Rating	Market Value %
BBB-	3.34%
BB+	7.56%
BB	18.71%
BB-	25.72%
B+	16.08%
B	15.29%
B-	8.48%
CCC+	1.42%
Other	2.08%

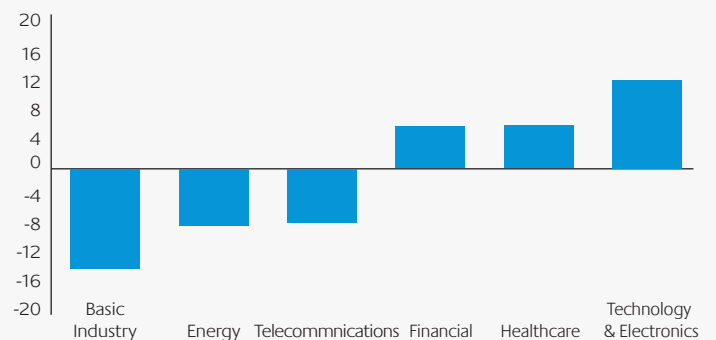
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United Kingdom	1.87%
Israel	0.37%
Other	0.00%

## Top 10 Issuers

Issuer	Market Value %
Asurion	2.58%
Frontier Communications Corp	2.57%
Sprint Corp	2.49%
Bausch Health Companies Inc	2.22%
Donnelley Financial Solutions Inc	2.08%
CSC Holdings	2.01%
Tempur Sealy International Inc	1.55%
First Data Corp	1.54%
Summit Materials	1.44%
Novelis	1.42%

## Top 3/Bottom 3 Contribution to Excess Return



## Sector & Issuer

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**Donnelley Financial Solutions (DFIN):** Donnelley Financial was a positive contributor due to the combination of a modest increase in bond price and its meaningful 2+% portfolio weighting. The \$60mm of net proceeds from the sale of its non-core language solutions business are targeted for debt reduction. Donnelley has not paid shareholder dividends or instituted a stock repurchase program. Despite somewhat elevated CapEx needs over the next year, free cash flow should still equate to 7-8% of gross debt.

### Negative Contributors (bottom three):

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## Co-Portfolio Managers: High Yield

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**Jason Epstein**  
Senior Portfolio Manager

Jason joined First State Investments in September 2016. He has 17 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.

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