

First State Investments High Yield

Q1 2019 | Co-Portfolio Managers: Matt Philo & Jason Epstein

“Nations, like individuals, cannot become desperate gamblers with impunity. Punishment is sure to overtake them sooner or later.”

– Charles Mackay

“Being early is the same as being wrong.”

– Bobby “Axe” Axelrod (*Billions*, S2 Ep5)

Thoughts on the Market

It seems to us that global central banks (“GCBs”) have repeatedly made it clear that “sooner or later” is meant to encapsulate “being early.” While the wisdom and efficacy of nearly two decades of unprecedented monetary stimulus by the GCBs is open to debate, its effect on financial asset prices seems well established, to us.

In our view, investment managers have generally chosen one of two basic overriding strategies in the face of the GCBs long-term, blunt-force, monetary muscle:

1. Strategy #1: Largely ignore the perceived “GCB put” and remain faithful to investment process and investment strategies. (Note: “GCB put” refers to an expectation that any meaningful decline in financial market asset values will be mitigated by additional, aggressive monetary stimulus by the GCBs).

Our FSI High Yield team has chosen to remain 100% faithful to our disciplined, fundamental investment process. This old-school stubbornness is less noble than we could claim because we retain complete conviction that our investment process should continue to outperform our relevant benchmarks and peer group managers, over time: **QE or no-QE**, so to speak.

2. Strategy #2: Adapt investment strategies and/or investment processes that rely on the “GCB put” (in our opinion). Effectively, wager (with investors’ assets) that **“sooner or later”** is **“late enough.”**

The investment management industry is predictable, if nothing else; never letting a bull-market go to waste in pursuit of higher fees via financial engineering. Please see: [Analysis: Private “Free Lunch” Funds on page 4.](#)

We hope it’s clear that our High Yield group’s unwavering commitment to our time-tested investment process is a permanent condition. We have been quite outspoken about our expectations regarding global central banks in every quarterly commentary since the Fed and ECB, in particular, began to talk about shrinking their

respective balance sheets; aka quantitative tightening (“QT”). The following are short excerpts from our previous commentaries:

Q1 2018: *“...The storyline of ‘QT’ pundits (quantitative tightening) lies somewhere between naive and fanciful. In short, \$20 trillion of stimulus injected directly into financial markets will not be methodically withdrawn regardless of the effects on global asset prices (the real ‘data’ in former Fed Chair Yellen’s term ‘data dependent’).”*

“...Mario Draghi’s ‘Whatever it takes’ speech remains our base case expectation for the CBs: ‘more of the same’.”

Q2 2018: *Analysis: A “No-QE World”?*

“Saying is one thing and doing is another.” – Michel de Montaigne (~1580)
“Market strategists and economic analysts continue to chatter about the upcoming ‘no-QE world.’ We remain entirely skeptical...”
“We seem to have been “here” before...We see a recurring theme of “hot potato” amongst the four major global Central Banks: ...Here in mid-2018, our “global worry list” is as long as usual: e.g. emerging market volatility, EU political uncertainty etc. Nevertheless, ‘this time is different’ and a ‘no-QE world’ is on the horizon? Not a chance in our opinion.”

Q3 2018: *“...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.”*

Q4 2018: *“A concise summary of the causes of this downside market correction begins, and ends with the admission that we really have no idea...We could cite the strong dollar (weak yuan), Chinese trade tensions, earnings warnings from the likes of CAT & PPG, the supposed onset of sustained central bank ‘QT’; etc. The only problem being we would have no cohesive idea what we were talking about.”*

“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.”

Q1 2019:

Exhibit 1: Returns of Various Assets

Asset Class	1Q'19	Mar'19	CY 2018	4Q'18	3Q'18	2Q'18	1Q'18
S&P 500	13.65%	1.94%	-4.40%	-13.52%	7.71%	3.43%	-0.76%
Emerging Market Stocks	9.56%	0.68%	-14.60%	-7.60%	-1.00%	-7.78%	1.24%
10-Year US Treasury	3.10%	2.84%	-0.03%	3.86%	-1.10%	-0.30%	-2.39%
Investment Grade Corp	5.01%	2.49%	-2.25%	0.06%	0.96%	-0.94%	-2.20%
US High Yield Corp Bonds	7.40%	0.98%	-2.27%	-4.67%	2.44%	1.00%	-0.91%
Leveraged Loans	3.89%	-0.16%	1.08%	-3.16%	2.00%	0.74%	1.58%
Euro High Yield Corps	5.28%	1.10%	-3.63%	-3.59%	1.67%	-1.21%	-0.48%
EM High Yield Corps	5.98%	0.74%	-2.29%	-0.14%	1.59%	-3.26%	-0.44%
<i>US High Yield by Rating</i>							
BB US High Yield Corps	7.36%	1.30%	-2.57%	-3.05%	2.31%	-0.12%	-1.66%
B US High Yield Corps	7.35%	0.93%	-1.72%	-4.91%	2.32%	1.43%	-0.40%
CCC US High Yield Corps	7.89%	0.31%	-4.91%	-10.32%	2.80%	2.59%	0.55%

Source: JP Morgan, ICE BAML

To quickly put the asset class returns represented in the first seven lines of Exhibit 1 in context:

Note that 7 of 8 asset classes posted *negative* returns in both 4Q'18 and CY 2018.

Yet, at the end of Q1'19, 7 of the 8 asset classes posted *positive* returns for trailing 2 quarters, and 5 quarters. Only the S&P 500 was down for the 2 quarters ending Q1'19 (-1.7%), and only MSCI EM Stocks was down for the 5 quarters ending Q1'19 (-6.4%).

Meanwhile, in Q4'18 WTI crude oil declined from a 2018 high of \$75.51 per barrel to the year's low of \$43.55, only to rebound to the new year's high of \$60.14 at the end of Q1'19; all in less than 6 months.

In fact, almost all global asset classes were positive during Q1'19: Global sovereign bonds, corporate bonds, equities and commodities. A nearly all-inclusive "everything rally."

At the end of Q4'18 we admitted to having no real clue why most global markets had traded down. We have no similar uncertainty regarding the fierce Q1'19 rally: **Global Central Banks!**

- The **ECB** pushed the timing of its first post-crisis rate hike until 2020, at the earliest; and offered another round of cheap loans to EU banks (TLTRO program).
- China's Aggregate Financing is reported to have increased by \$1.224 TN during Q1'19 according to the **PBOC; probably the strongest three-month credit expansion in history.**
- The U.S. **Fed's** last discount rate increase was Dec'18 and it will not hike rates during 2019. In addition, the Fed will again reinvest maturing UST and MBS bonds in Sep'19.
- Of course, the **BOJ** continues to ease "persistently."

High Yield Market Commentary

The U.S. HY market, as represented by the ICE BofAML US High Yield Constrained Index (HUCO) produced an impressive 7.4% total return during Q1'19, its strongest quarterly return since 2009. January was the strongest month in Q1'19 as investors quickly erased the "air-pocket" declines of Dec'18 with a price increase of 3% in just the first 8 trading days.

For the quarter, the CCC-rated tranche of the Index very modestly outperformed the single-B and BB tranches. In March, a strong rally in UST bonds resulted in BB's outperforming CCC's by ~100 bps.

* 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.

Within our portfolios, the strongest performing sectors were Basic Industry, Communications and Consumer Non-Cyclicals. Basic Materials benefitted from particular relative strength in Metals and Mining (e.g. see: *Coeur Mining* in "Positive Contributors"). Communications saw the greatest relative contribution in Cable & Satellites (e.g. see *Inmarsat* in "Positive Contributors"). Consumer Products led the way as a positive contributor within the Consumer Non-Cyclicals sector (e.g. see *Energizer Holdings* in "Positive Contributors"); however, in Healthcare an underweight in Healthcare Services nearly offset the strong performance of our Pharmaceutical holdings (e.g. see *Bausch Health & Endo Int'l* in "Positive Contributors").

Conversely, the sectors making the weakest contribution to performance included Consumer Cyclical, due to our lack of exposure in the Retail, Restaurant and Consumer Cyclical Services industries. The Energy sector was the second weakest contributor despite the E&P industry generating the greatest positive attribution of any industry in our portfolios (even with one credit mistake; see: *EP Energy* in "Negative Contributors"); the strong E&P performance was more than offset by our modest exposure to the Oil Field Services and Midstream industries.

Our High Yield composites comfortably outpaced their index benchmarks during January and February but gave back most of that outperformance in March. We quickly recouped underperformance in Dec'18 and always expect that to be the case as we maintain process discipline and rely on solid credit selection. However, two quarters in a row ending with a relatively weak month make us glad we're not superstitious PM's. Generally speaking, we are pleased with our Composites' performance. While we always want to outperform, even during particularly strong market runs, our primary focus remains on implementing our naturally contrarian investment process in order to outperform during any meaningful market pullback, or a more serious downturn.

Summary:

The HUCO Index, began the third quarter, **30-Sep-2018** as follows: A yield-to-worst of 7.95%, spread-to-worst of +539 bps, duration-to-worst of 4.3 and an average price of 92.31.

At the **end of Q1'19**, the HUCO Index presented: A yield-to-worst of 6.48%, spread-to-worst of +417 bps, duration-to-worst of 3.7 and an average price of 97.69.

Portfolio Positioning

The relative positioning of our various High Yield Composites* remained roughly the same: Broad HY, 3 bps tighter than the previous quarter; Select HY, 21 bps tighter; Quality HY 3 bps wider; Short Duration HY, 10 bps tighter; and Defensive HY 22 bps tighter.

Our team was active in the portfolios during the quarter, which is to be expected whenever the overall market experiences a strong rally, or decline. Fortunately, price differentiation in the High Yield market during broad market moves is even less efficient than usual, from the perspective of our investment process.

We added meaningful new positions early in the quarter: e.g. a group 3 credit in the consumer products sector with a STW well above +500 bps, and a group 2 credit in non-food retailing offering a STW well above +400 bps.

As the strong rally progressed in Q1'19 our investment process directed us to exit, or lighten weights in a number of weak group 2 and group 3 credits on price strength, particularly within the Basic Industry sectors such as Chemicals and Metals & Mining. However, our portfolios maintained that sector overweight as an equal number the most attractive relative values identified by our investment process happened to fall within that same sector.

We added to a number of E&P credits presenting attractive default adjusted spreads as there was something of a technical disconnect between credit pricing in that sector relative to the strong rebound in the price of WTI crude oil.

We ended Q1'19 with sector weightings relative to the benchmark indexes similar to the beginning of the quarter. Within those sector weights we did see a modest increase in credit quality, based on our proprietary risk group categories. In general, the largest sector overweight was in Basic Materials; in particular, Metals & Mining & Chemicals. Our largest sector underweight remains in Financials with our average Composite owning just two credits, while the average benchmark weight is nearly 8%. Our second largest sector overweight is in Consumer Non-Cyclicals; driven by holdings in the Pharmaceutical and Consumer Products industries. Our second largest sector underweight is Consumer Cyclicals, driven by a general lack of exposure in all sector industries except Automotive.

At the end of 4Q'18 we proclaimed, "U.S. High Yield is On Sale!". After the strong Q1'19 rally we retain conviction that U.S. High Yield remains the best value in fixed income, in our opinion. We believe our Composite portfolios are cheap relative to the cumulative default risk of their holdings, and should prove resilient if/when the global economy weakens and/or credit availability tightens.

As usual, we remind all investors: 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.

Composite Performance Summary

High Yield Composites - Annualized

As of March 31, 2019						
	1Q-2019	Mar-19	Feb-19	Jan-19	2018	Since Inception (Annualized)
Broad High Yield	7.49%	0.59%	2.13%	4.63%	-1.62%	5.17%
ICE BofAML US High Yield Constrained Index	7.40%	0.98%	1.69%	4.59%	-2.27%	4.41%
Active Performance	0.09%	-0.39%	0.45%	0.04%	0.65%	0.76%
Select High Yield	7.86%	0.57%	2.18%	4.96%	-2.06%	5.09%
ICE BofAML US High Yield Constrained Index	7.40%	0.98%	1.69%	4.59%	-2.27%	4.41%
Active Performance	0.46%	-0.41%	0.49%	0.37%	0.21%	0.68%
Quality High Yield	7.20%	0.61%	2.10%	4.36%	-1.34%	5.18%
ICE BofAML BB-B US High Yield Constrained Index	7.34%	1.12%	1.65%	4.43%	-2.04%	4.42%
Active Performance	-0.14%	-0.51%	0.45%	-0.07%	0.71%	0.76%
Defensive High Yield	6.46%	0.57%	1.82%	3.97%	-0.83%	4.94%
ICE BofAML BB-B US High Yield Constrained Index	7.34%	1.12%	1.65%	4.43%	-2.04%	4.42%
Active Performance	-0.88%	-0.55%	0.17%	-0.46%	1.21%	0.52%
Short Duration High Yield	5.22%	0.50%	1.33%	3.32%	0.53%	4.46%
ICE BofAML 1-5 Yr BB-B US Cash Pay HY Constrained Index	5.49%	0.74%	1.30%	3.37%	0.67%	4.58%
Active Performance	-0.27%	-0.24%	0.04%	-0.06%	-0.15%	-0.12%

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.

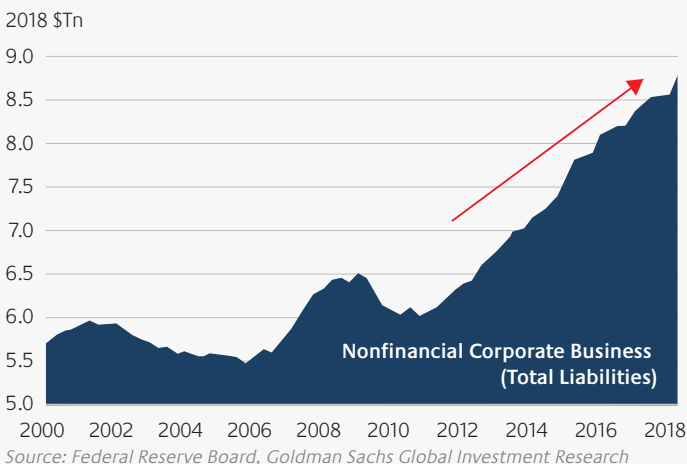
Analysis: Private “Free Lunch” Funds

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



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		
Mezzanine	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.

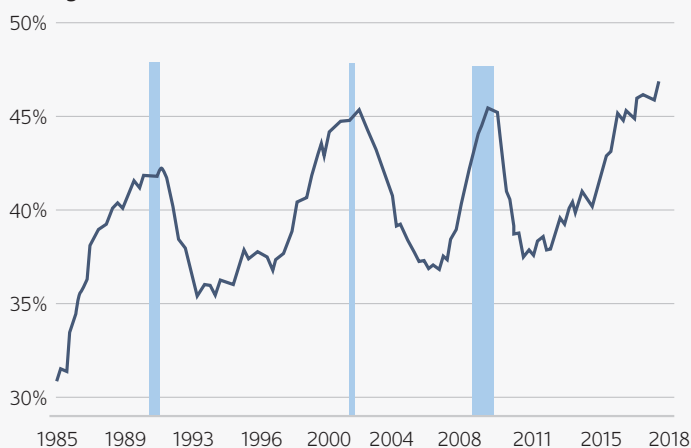
We don't single-out Direct Lending credit funds for any reason except they operate in a non-investment grade world we know something about. We readily assume that the flood of investor money into every flavor of PCFs has produced general excesses across the board.

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

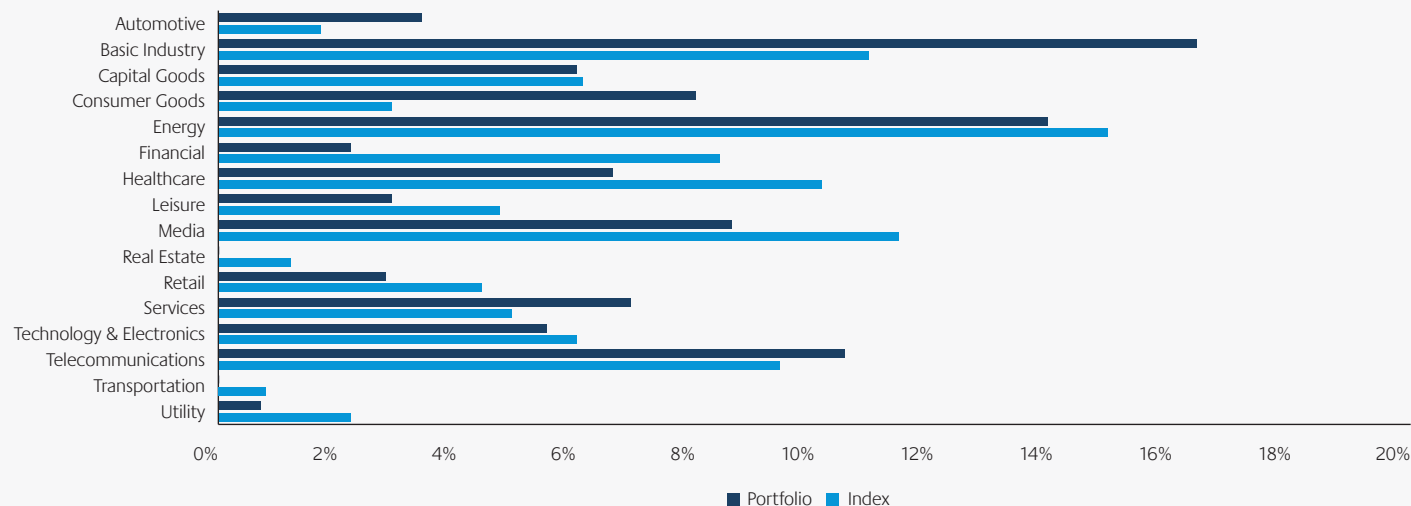
Perhaps this time IS different. If so, the critical question then becomes HOW different.

Broad High Yield

Characteristics

	Broad	Index
Yield to Worst*	6.19%	6.39%
Spread to Worst (bps)	391	407
Duration to Worst (years)	3.33	3.62
# of Issuers	124	
Avg. Rating	B1/BB-	

Sector weightings: Portfolio, Benchmark



Breakdown by Rating

Rating	Market Value %
BBB-	2.2
BB+	3.6
BB	17.8
BB-	16.6
B+	17.8
B	14.7
B-	14.2
CCC+	3.9
CCC	2.2
CCC-	0.0
Other	1.7

Top 10 Issuers

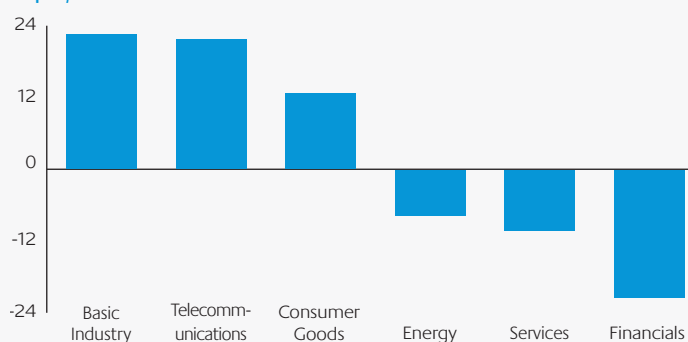
Issuer	Market Value %
Bausch Health	2.07
Brookfield Residential Properties	2.05
Sprint	1.92
Asurion	1.87
Frontier Communications	1.73
Horizon Pharmaceuticals	1.67
Energizer Holdings	1.63
Reynolds Group	1.62
Jagged Peak Energy	1.59
Charter Communications	1.59

■ Portfolio ■ Index

Breakdown by Country

Country	Risk Contribution %
United States	90.2
Canada	3.7
Australia	2.6
United Kingdom	1.4
France	1.0
Ireland	0.8
Israel	0.3

Top 3/Bottom 3 Contribution to Excess Return



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

Sector & Issuer

Positive Contributors (top three):

Bausch Health (BHCCN): Bausch Health outperformance during the quarter was due to good Q4'18 results and positive guidance for 2019. The company reported during the quarter, and beat expectations due to strong results in the eyecare, generics and international segments. As well, flat EBITDA expectations and positive cash flow for 2019 pleased the market. The company expects to continue to pay down debt with cash flow. We continue to hold bonds as we see a multi-year improving credit story.

Energizer (ENR): Energizer bonds outperformed during the quarter as the company announced fourth quarter results which exceeded consensus estimates and positive battery trends observed through Nielsen data continued. The Company also provided an updated timeline to closing its recently announced Spectrum Brands acquisitions which have since closed.

Coeur Mining (CDE): Coeur Mining bonds outperformed during the quarter on the back of gold and silver price rallies and broader market strength. Gold miner valuations were also supported by the announcement of a merger between Barrick and Newmont which spurred speculation about additional acquisition activity in the space. We view Coeur, in its entirety, as an unlikely target due to its small scale and position on the cost curve but believe there is some possibility for certain land package divestitures. We believe the company's undeveloped land assets, and ongoing balance sheet management provide it with levers to help manage liquidity despite operational issues ramping production at the recently acquired Silvertip mine.

Negative Contributors (bottom three):

EP Energy (EPENEG): EP Energy underperformance during the quarter was due to weak Q4'18 results. The company reported dwindling liquidity as well a write-down on part of its portfolio. While we had comfort that our position in the 1.125 lien bonds was well covered by the proved value of the developed assets, we decided to exit the position in the first quarter due to lack of liquidity and the lack of transparency by management regarding the direction of the company and their capital structure.

Nielsen (NLSN): Nielsen bonds underperformed during the quarter following headlines that some private equity firms were losing interest in making a bid for the company. Subsequent to quarter end there have been new headlines suggesting that the sale process remains ongoing, with several interested suitors. We believe a sale of the company or its Connect business would drive upside in bonds, and that downside is limited in the event of no M&A owing to the strength of the company's dominant Media business.

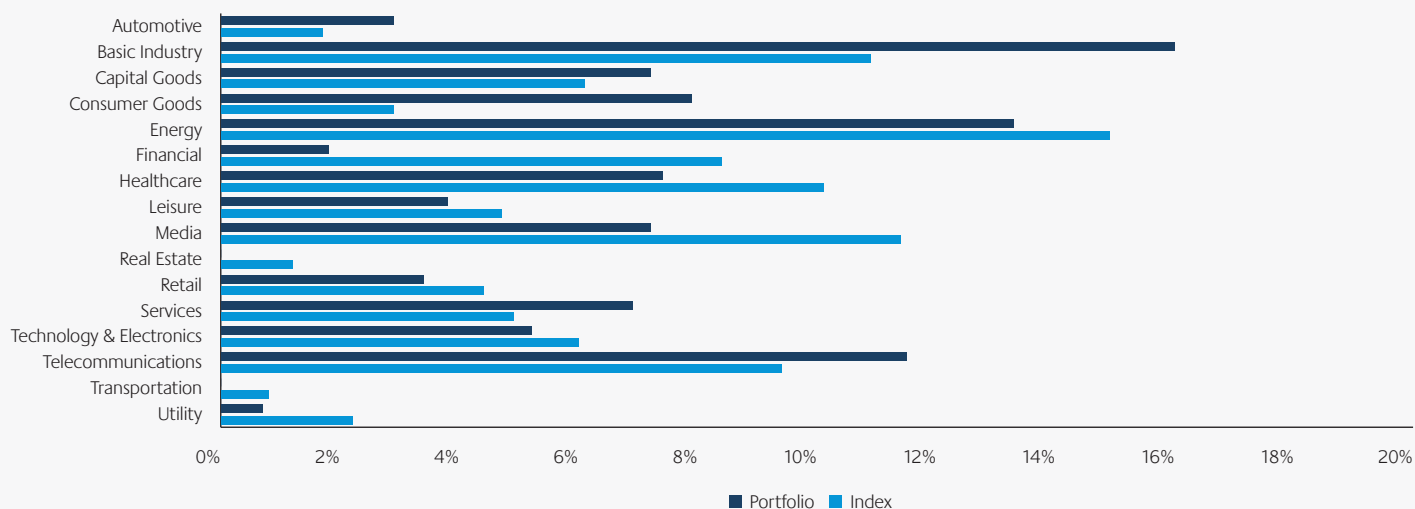
Clearway Energy (CWENA): Clearway Energy bonds underperformed during the quarter following PG&E Corp's bankruptcy filing due to wildfire exposure. Clearway has a large existing contract with PG&E, and there was some concern in the market whether or not PG&E would try to reject and/or renegotiate the contract while in bankruptcy. This fear has subsided more recently, and we no longer hold the bonds.

Select High Yield

Characteristics

	Select	Index
Yield to Worst*	6.49%	6.39%
Spread to Worst (bps)	420	407
Duration to Worst (years)	3.46	3.62
# of Issuers	114	
Avg. Rating	B2/B+	

Sector weightings: Portfolio, Benchmark



Breakdown by Rating

Rating	Market Value %
BBB-	2.2
BB+	2.5
BB	16.1
BB-	15.5
B+	16.8
B	12.4
B-	16.7
CCC+	7.8
CCC	4.6
CCC -	0.0
Other	1.3

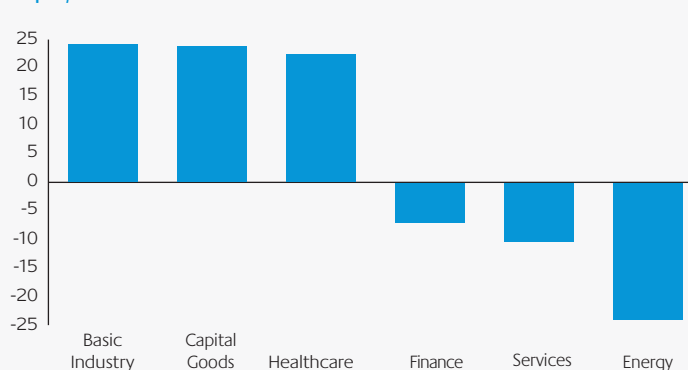
Breakdown by Country

Country	Risk Contribution %
United States	91.9
Canada	3.1
Australia	1.5
Ireland	1.5
France	1.2
United Kingdom	0.4
Israel	0.4

Top 10 Issuers

Issuer	Market Value %
Brookfield Residential Properties	2.40
Iridium Communications	2.33
Bausch Health	2.28
Asurion	2.21
Horizon Pharmaceuticals	2.10
Sprint	2.03
California Resources	2.02
Geo Group	1.84
Reynolds Group	1.70
Vista Outdoor	1.68

Top 3/Bottom 3 Contribution to Excess Return



Sector & Issuer

Positive Contributors (top three):

Endo International (ENDP): Endo outperformance during the quarter was largely due to our ownership of the company's 2022 unsecured bonds. During the quarter, Endo took the opportunity to access the capital markets and issue secured debt to tender for multiple issues of their shorter-dated unsecured bonds, including the '22 bonds that we own. We tendered our bonds at par, having started the quarter trading below 90.

Bausch Health (BHCCN): Bausch Health outperformance during the quarter was due to good Q4'18 results and positive guidance for 2019. The company reported during the quarter, and beat expectations due to strong results in the eyecare, generics and international segments. As well, flat EBITDA expectations and positive cash flow for 2019 pleased the market. The company expects to continue to pay down debt with cash flow. We continue to hold bonds as we see a multi-year improving credit story.

Coeur Mining (CDE): Coeur Mining bonds outperformed during the quarter on the back of gold and silver price rallies and broader market strength. Gold miner valuations were also supported by the announcement of a merger between Barrick and Newmont which spurred speculation about additional acquisition activity in the space. We view Coeur, in its entirety, as an unlikely target due to its small scale and position on the cost curve but believe there is some possibility for certain land package divestitures. We believe the company's undeveloped land assets, and ongoing balance sheet management provide it with levers to help manage liquidity despite operational issues ramping production at the recently acquired Silvertip mine.

Negative Contributors (bottom three):

EP Energy (EPENEG): EP Energy underperformance during the quarter was due to weak Q4'18 results. The company reported dwindling liquidity as well a write-down on part of its portfolio. While we had comfort that our position in the 1.125 lien bonds was well covered by the proved value of the developed assets, we decided to exit the position in the first quarter due to lack of liquidity and the lack of transparency by management regarding the direction of the company and their capital structure.

Nielsen (NLSN): Nielsen bonds underperformed during the quarter following headlines that some private equity firms were losing interest in making a bid for the company. Subsequent to quarter end there have been new headlines suggesting that the sale process remains ongoing, with several interested suitors. We believe a sale of the company or its Connect business would drive upside in bonds, and that downside is limited in the event of no M&A owing to the strength of the company's dominant Media business.

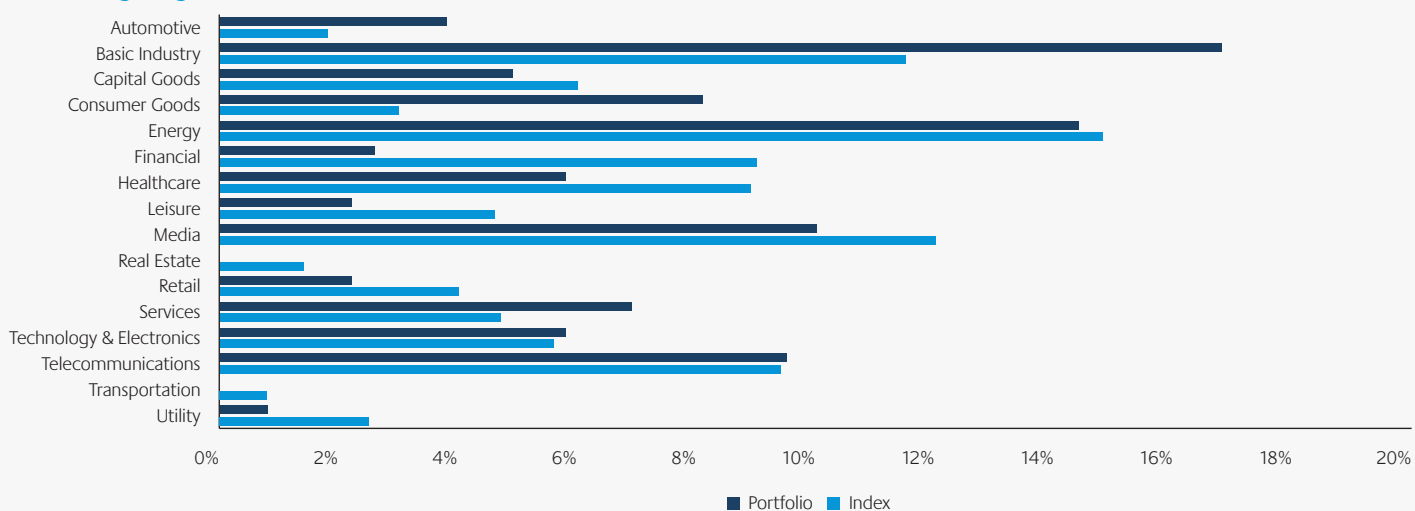
McDermott International (MDR): McDermott underperformed during the quarter due a Q4'18 that saw EBITDA below expectations and continued charges taken on existing contracts. However, we take comfort from the fact that asset sales still appear to be on track and 2019 guidance looks positive. In addition, we believe new management has credibility and this has been proven by substantial new contract awards announced in 2019. We continue to hold term loans and look for continued improvement throughout 2019.

Quality High Yield

Characteristics

	Quality	Index
Yield to Worst*	5.92%	5.70%
Spread to Worst (bps)	363	338
Duration to Worst (years)	3.20	3.66
# of Issuers	113	
Avg. Rating	B1/BB-	

Sector weightings: Portfolio, Benchmark



Breakdown by Rating

Rating	Market Value %
BBB-	2.2
BB+	4.7
BB	19.4
BB-	17.7
B+	18.9
B	16.7
B-	11.9
CCC+	0.4
Other	2.1

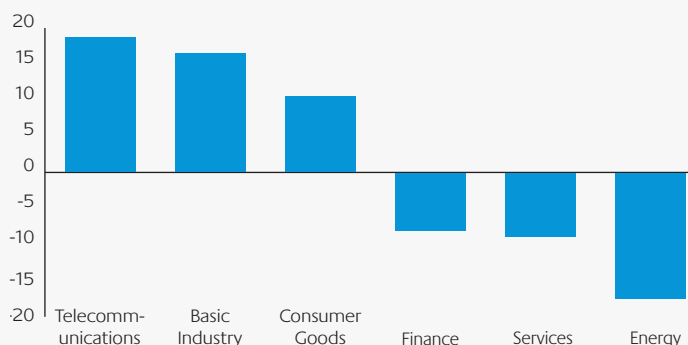
Breakdown by Country

Country	Risk Contribution %
United States	91.1
Australia	4.3
Canada	3.0
France	0.6
United Kingdom	0.5
Israel	0.5

Top 10 Issuers

Issuer	Market Value %
Frontier Communications	2.09
Bausch Health	1.88
Sprint	1.83
Energizer Holdings	1.73
Brookfield Residential	1.71
Charter Communications	1.70
Asurion	1.55
Reynolds Group	1.54
Inmarsat Finance	1.54
Jagged Peak Energy	1.54

Top 3/Bottom 3 Contribution to Excess Return



Sector & Issuer

Positive Contributors (top three):

Energizer (ENR): Energizer bonds outperformed during the quarter as the company announced fourth quarter results which exceeded consensus estimates and positive battery trends observed through Nielsen data continued. The Company also provided an updated timeline to closing its recently announced Spectrum Brands acquisitions which have since closed.

Bausch Health (BHCCN): Bausch Health outperformance during the quarter was due to good Q4'18 results and positive guidance for 2019. The company reported during the quarter, and beat expectations due to strong results in the eyecare, generics and international segments. As well, flat EBITDA expectations and positive cash flow for 2019 pleased the market. The company expects to continue to pay down debt with cash flow. We continue to hold bonds as we see a multi-year improving credit story.

Inmarsat (ISATLN): Inmarsat outperformed during the quarter as a result of a buyout offer from a consortium led by Apax Partners, Warburg Pincus, and CPPIB. Our position traded up as the market agrees the bonds will be called if the acquisition were to occur. We continue to like the Inmarsat story as growth in Inflight Connectivity (IFC), Fleet Xpress (FX), and overall data consumption drive growth, despite weakness in the Maritime segment. We also like the prospect of an increased bid price for Inmarsat through negotiations with the consortium or even an alternative bid, increasing the likelihood that our bonds get called.

Negative Contributors (bottom three):

EP Energy (EPENEG): EP Energy underperformance during the quarter was due to weak Q4'18 results. The company reported dwindling liquidity as well a write-down on part of its portfolio. While we had comfort that our position in the 1.125 lien bonds was well covered by the proved value of the developed assets, we decided to exit the position in the first quarter due to lack of liquidity and the lack of transparency by management regarding the direction of the company and their capital structure.

Clearway Energy (CWENA): Clearway Energy bonds underperformed during the quarter following PG&E Corp's bankruptcy filing due to wildfire exposure. Clearway has a large existing contract with PG&E, and there was some concern in the market whether or not PG&E would try to reject and/or renegotiate the contract while in bankruptcy. This fear has subsided more recently, and we no longer hold the bonds.

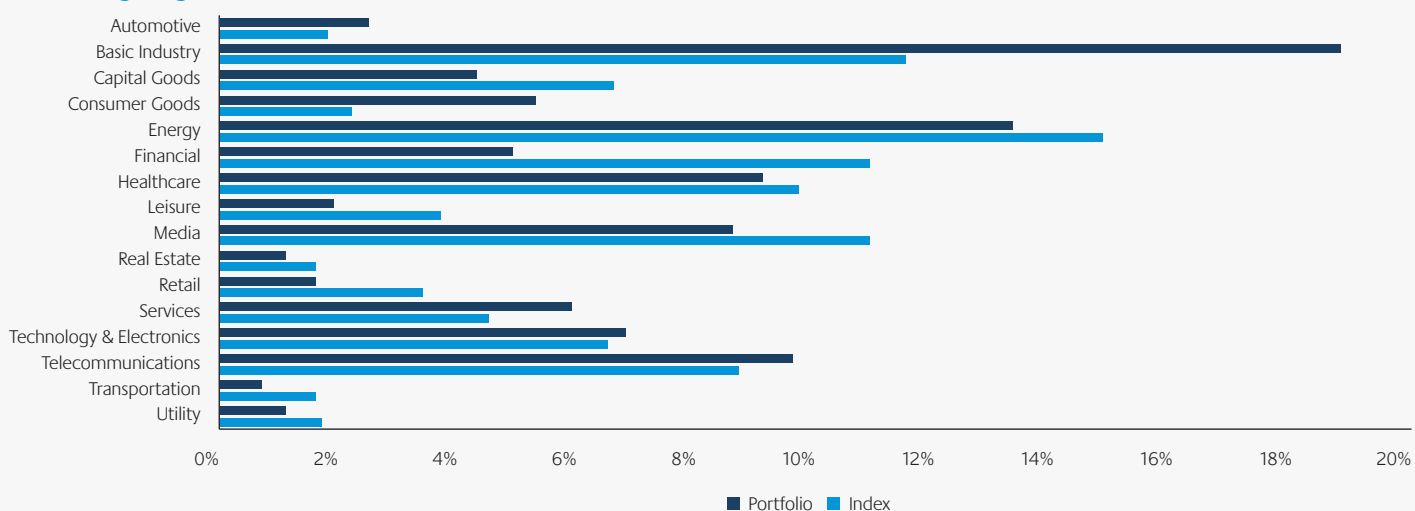
Nielsen (NLSN): Nielsen bonds underperformed during the quarter following headlines that some private equity firms were losing interest in making a bid for the company. Subsequent to quarter end there have been new headlines suggesting that the sale process remains ongoing, with several interested suitors. We believe a sale of the company or its Connect business would drive upside in bonds, and that downside is limited in the event of no M&A owing to the strength of the company's dominant Media business.

Short Duration High Yield

Characteristics

	Short Duration	Index
Yield to Worst*	5.20%	5.27%
Spread to Worst (bps)	291	297
Duration to Worst (years)	1.26	2.03
# of Issuers	94	
Avg. Rating	B1/ BB-	

Sector weightings: Portfolio, Benchmark



Breakdown by Rating

Rating	Market Value %
BBB-	2.6
BB+	6.4
BB	20.8
BB-	22.7
B+	16.2
B	14.4
B-	9.4
CCC+	0.3
Other	3.7

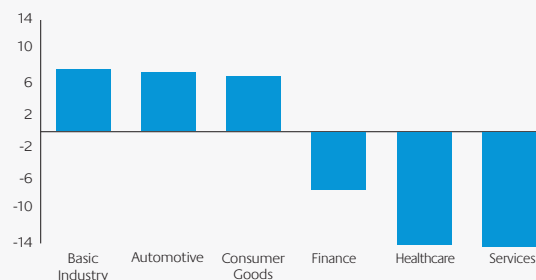
Breakdown by Country

Country	Risk Contribution %
United States	92.5
Australia	3.4
Canada	2.0
United Kingdom	0.7
Israel	0.7
Ireland	0.7

Top 10 Issuers

Issuer	Market Value %
Hecla Mining	2.56
Level 3	2.44
Clear Channel Outdoor	2.25
Icahn Enterprises	2.09
Sprint	2.07
Wesco Distribution	1.98
Bausch Health	1.89
Intelsat	1.79
Univar	1.76
Dell	1.72

Top 3/Bottom 3 Contribution to Excess Return



Sector & Issuer

Positive Contributors (top three):

Inmarsat (ISATLN): Inmarsat outperformed during the quarter as a result of a buyout offer from a consortium led by Apax Partners, Warburg Pincus, and CPPIB. Our position traded up as the market agrees the bonds will be called if the acquisition were to occur. We continue to like the Inmarsat story as growth in Inflight Connectivity (IFC), Fleet Xpress (FX), and overall data consumption drive growth, despite weakness in the Maritime segment. We also like the prospect of an increased bid price for Inmarsat through negotiations with the consortium or even an alternative bid, increasing the likelihood that our bonds get called.

Bombardier (BBDBCN): Bombardier bonds outperformed during the quarter after the company refinanced shorter-dated notes and made a small tender offer for the 8 ¾ senior notes due 2021. Bond prices were also supported by management's intimation that they would be prudent around buying back CDPQ's stake in its Transportation business. Management's comments alleviated the market's concern around the potential for additional balance sheet leverage as the company completes its turnaround. At current levels, we believe the shorter-dated bonds are appropriately valued.

Meritor (MTOR): Meritor bonds outperformed during the quarter after reporting another strong set of results outperforming consensus estimates. Over the last several years, management has prudently paid down debt with cash generated from a heavy duty truck upcycle. As the end market is showing some signs of peaking and the bonds have outperformed, we have trimmed the position now that relative value is less compelling.

Negative Contributors (bottom three):

Nielsen (NLSN): Nielsen bonds underperformed during the quarter following headlines that some private equity firms were losing interest in making a bid for the company. Subsequent to quarter end there have been new headlines suggesting that the sale process remains ongoing, with several interested suitors. We believe a sale of the company or its Connect business would drive upside in bonds, and that downside is limited in the event of no M&A owing to the strength of the company's dominant Media business.

McDermott International (MDR): McDermott underperformed during the quarter due a Q4'18 that saw EBITDA below expectations and continued charges taken on existing contracts. However, we take comfort from the fact that asset sales still appear to be on track and 2019 guidance looks positive. In addition, we believe new management has credibility and this has been proven by substantial new contract awards announced in 2019. We continue to hold term loans and look for continued improvement throughout 2019.

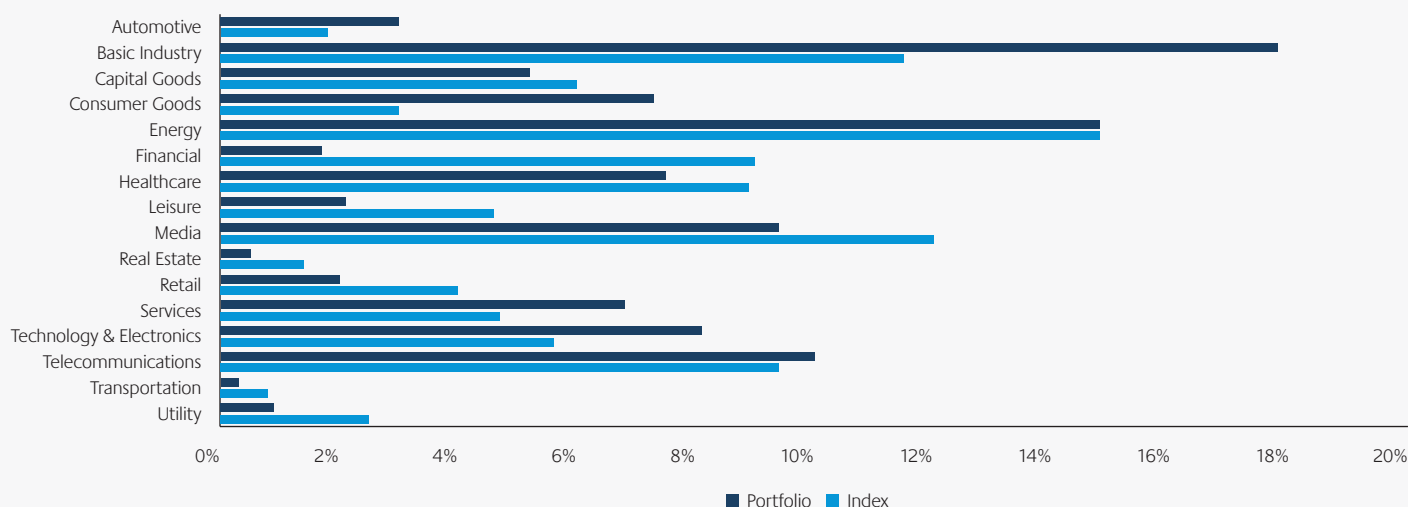
Beacon Roofing Supply (BECN): Beacon Roofing underperformed during the quarter due to a disappointing guidance revision for its upcoming second fiscal quarter and fiscal year. The revision was driven by disruptive weather during February and March. We view the impacts as transitory and believe the term loan continues to offer compelling relative value.

Defensive High Yield*

Characteristics

	Defensive	Index
Yield to Worst*	5.62%	5.70%
Spread to Worst (bps)	326	338
Duration to Worst (years)	2.52	3.66
# of Issuers	136	
Avg. Rating	B1/BB-	

Sector weightings: Portfolio, Benchmark



Breakdown by Rating

Rating	Market Value %
BBB-	2.8
BB+	5.3
BB	20.9
BB-	20.2
B+	19.2
B	16.3
B-	9.9
CCC+	0.3
Other	2.1

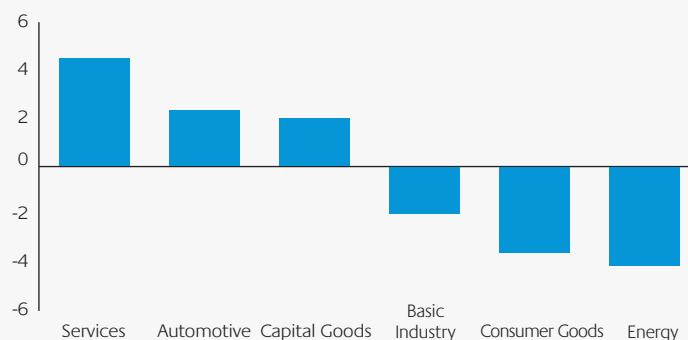
Breakdown by Country

Country	Risk Contribution %
United States	91.7
Australia	4.0
Canada	2.6
United Kingdom	0.6
Israel	0.6
France	0.4
Ireland	0.3

Top 10 Issuers

Issuer	Market Value %
Bausch Health	2.23
Sprint	1.96
Hecla Mining	1.81
Clear Channel	1.79
Brookfield Residential	1.66
Reynolds Group	1.59
Asurion	1.55
PDC Energy	1.53
CSC Holdings	1.52
Financial & Risk US Holdings	1.50

Top 3/Bottom 3 Contribution to Excess Return



* 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):

Inmarsat (ISATLN): Inmarsat outperformed during the quarter as a result of a buyout offer from a consortium led by Apax Partners, Warburg Pincus, and CPEIB. Our position traded up as the market agrees the bonds will be called if the acquisition were to occur. We continue to like the Inmarsat story as growth in Inflight Connectivity (IFC), Fleet Xpress (FX), and overall data consumption drive growth, despite weakness in the Maritime segment. We also like the prospect of an increased bid price for Inmarsat through negotiations with the consortium or even an alternative bid, increasing the likelihood that our bonds get called.

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Clearway Energy (CWENA): Clearway Energy bonds underperformed during the quarter following PG&E Corp's bankruptcy filing due to wildfire exposure. Clearway has a large existing contract with PG&E, and there was some concern in the market whether or not PG&E would try to reject and/or renegotiate the contract while in bankruptcy. This fear has subsided more recently, and we no longer hold the bonds.

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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.

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