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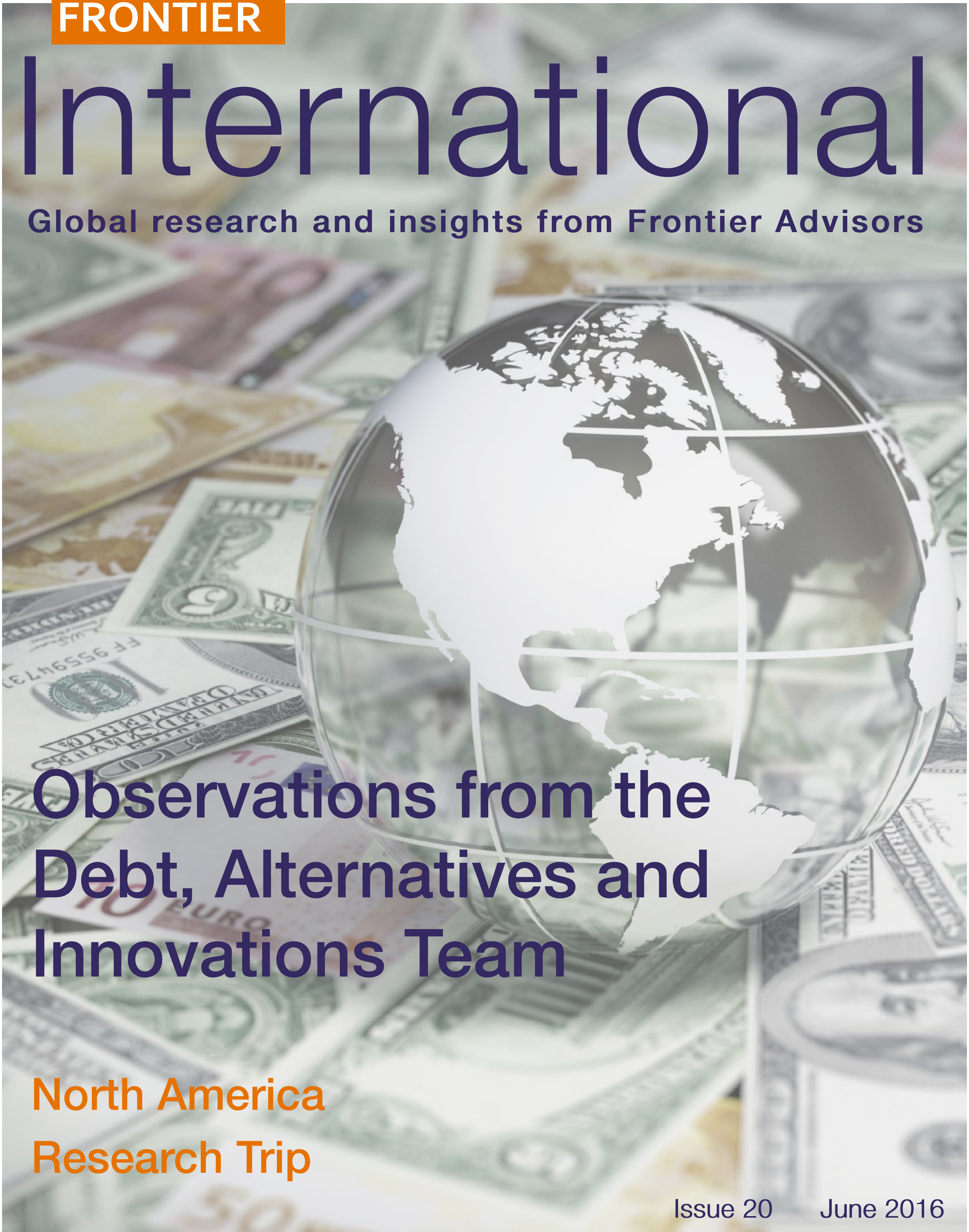

Observations from the Debt, Alternatives and Innovations Team

North America Research Trip

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Frontier regularly conducts international research trips to observe and understand more about international trends, and to meet and evaluate first hand a range of fund managers and products.

The most recent trip focused on manager capabilities in the high yield credit space, but also involved meetings with managers in the multi-sector debt, bank loans, and opportunistic credit sectors in a range of US markets.

This report provides a high level assessment on the key areas and observations unearthed during this recent research venture. We would be pleased to meet with you in person to provide further detail on these observations.

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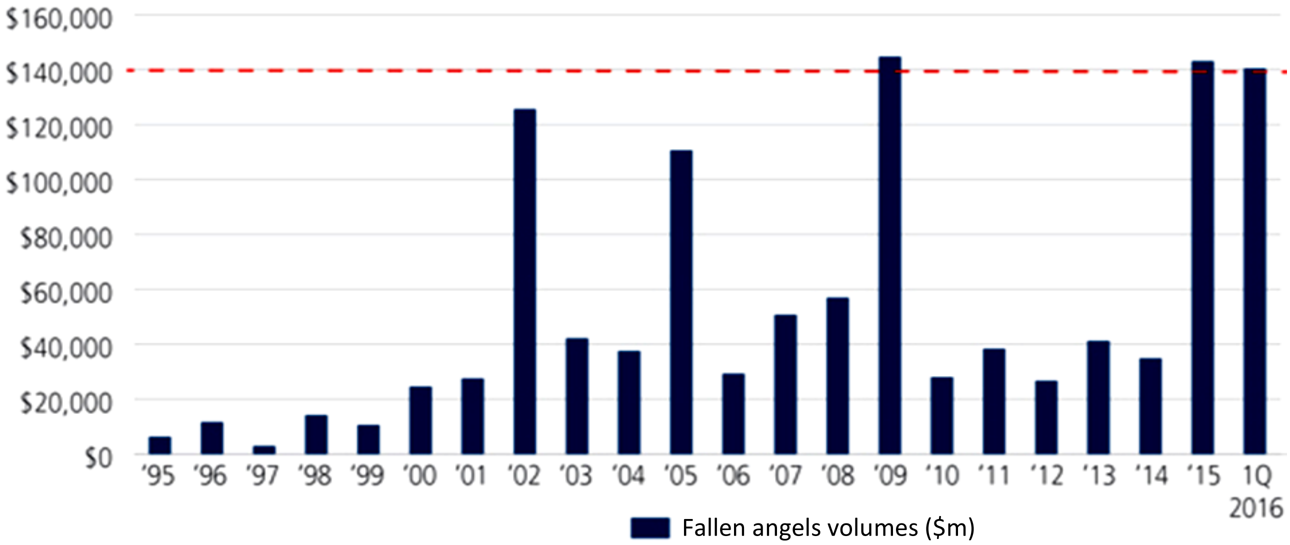
Fallen angels

On the back of a lower oil price, fallen angels—formerly investment grade bonds that have been downgraded to non-investment grade ratings have increased. They have become a hot topic when discussing the investment grade and high yield credit markets.

While fallen angels are not a new phenomenon, the sheer quantity of downgrades (both in number and dollars) has been significant in recent times - as shown below. The record dollar amount of fallen angels occurred in 2009, closely followed by 2015, at US$145 billion and $143 billion respectively. The first quarter of 2016 alone has seen approximately US$140 billion already, with 20 of the 26 new US fallen angels downgraded in Q1 coming from within the Energy and Metals and Mining sectors.

Looking forward, the potential for further downgrades will largely depend on commodity prices. Several managers that Frontier met with in the US anticipate further downgrades, although the vast majority believe that the quantum of downgrades will taper off from here.

Chart 1: Quarter 1, 2016 was the third biggest "year" ever for fallen angels



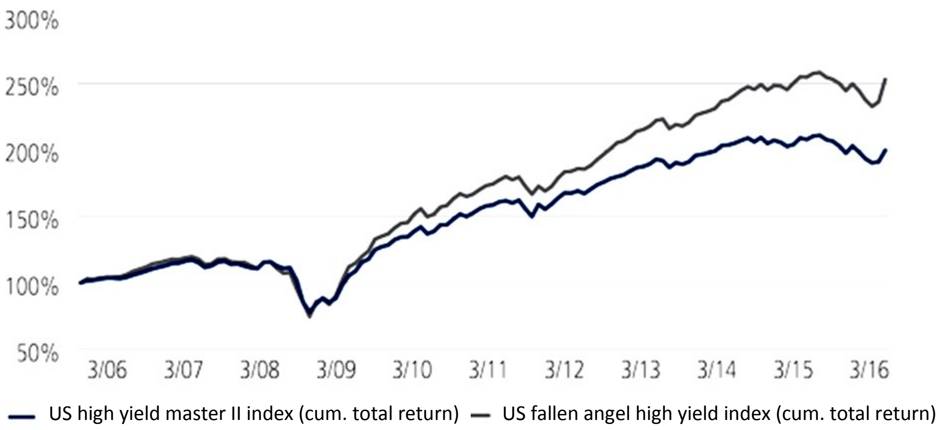
Source: JPMorgan

So what are the potential ramifications of fallen angels for credit markets?

Firstly, fallen angels have resulted in a notable increase in the composition of the BB segment of the high yield universe. Many managers will therefore argue that, at least temporarily, the quality of the high yield market has increased.

Most managers agree (regardless of whether they have a high yield capability) – that fallen angels present a material investment opportunity for sub-investment grade managers. This is because historically, fallen angels have outperformed the broader high yield market, as shown below.

Chart 2: Fallen angels have outperformed the broader high yield market in the U.S.



Source: JPMorgan

There are several reasons for this:

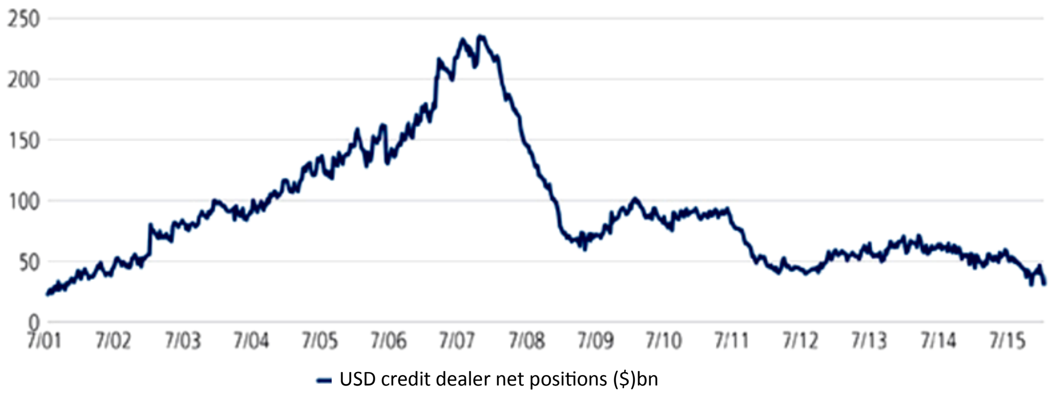
- By the time most fallen angels have entered the high yield space, the 'bad news' regarding the company has been priced in (often overly so due to forced selling by investment grade managers). Similarly, many benchmark aware high yield managers (and ETFs) are forced to start buying fallen angels in order for them to continue to track their respective benchmark, and this provides some level of price support in many cases;
- The vast majority of fallen angels are actually high quality, true investment grade issuers that are suffering due to relatively short term, external forces (i.e. their balance sheets are not structurally 'broken'). As a result, their performance is often less volatile and they generally settle in the upper rating tiers of the high yield universe; and
- Related to the above, company management often have greater flexibility than other high yield issuers to effect change to improve company balance sheets. Many fallen angels eventually migrate back into the investment grade universe as a result.

In Frontier's view, benchmark agnostic high yield managers are best placed to capitalise on fallen angels. This is because they are able to be more selective in terms of which fallen angels to target and (for example) specifically target those companies with lower leverage and/or strong asset coverage, which helps to mitigate risks in the event of an extended period of low oil / commodity prices. Within the benchmark agnostic manager universe, those with an investment grade and high yield capability are arguably at an advantage, as it allows them to identify these companies in the early stages, as fundamentals start to deteriorate. This happens most effectively through communication between the investment grade and high yield teams, who can share thoughts on company management, capital structures, ability to raise capital etc. and allow the high yield team to move quickly if required.

High Yield Market Liquidity

Since 2008, regulation has drained liquidity from fixed income markets. Basel III and the Volcker Rule have combined to make it costly and difficult for investment-bank dealer desks to hold inventories of securities on their balance sheets. Net dealer positions in both investment grade and non-investment grade credit have plummeted as a result. At its peak, primary dealers held approximately 4% of outstanding bonds, providing a buffer for increased sales volumes. This is now approximately 0.5%.

Chart 3: USD credit dealer net positions

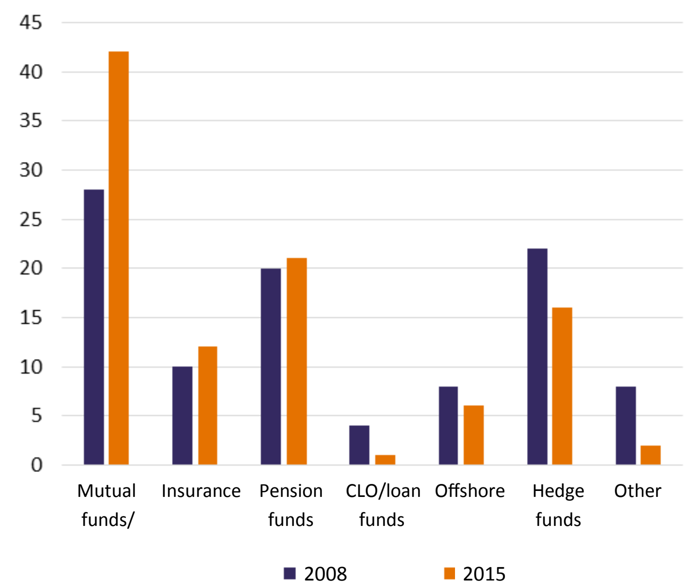


Source: Federal Reserve Bank of New York

While the number of bonds being held by bank dealers has collapsed, the size of the high yield market has grown substantially over the same period. This implies that the amount of investor capital targeting the high yield market has increased. In isolation, this is not necessarily a bad thing, and is an example of markets finding a new equilibrium in response to regulations.

However, what makes the high yield sector somewhat unique is the increasing proportion (and high absolute representation) of mutual funds and ETFs within the investor base. Many of these funds offer daily liquidity and are therefore susceptible to trading of bonds on sentiment, momentum and / or ratings changes.

Chart 4: Change in high yield investor composition (2008—2015)



Source: Barclays, KKR

Indiscriminate buying and selling by mutual funds in response to changes in sentiment has not only contributed to high yield market volatility, but also a reduction in liquidity. Many managers that Frontier met with in the US observed various implications of this, including:

- Within the energy space, many noted difficulties in aggregating positions in late 2015 (one opportunistic credit manager for example wanted to accumulate a 14% position in energy but could only get to 10% “without buying rubbish” given the lack of liquidity). These managers also observed reduced liquidity in early 2016, where the ability to transact on energy securities at anywhere near the quoted prices was restricted by the lack of buyers or sellers to trade with.
- More broadly, low liquidity is apparent in price gapping and diminished trading volumes, which creates difficulties in buying some positions. Extremely volatile price action has also occurred off the back of little to no real news.
- Less trading activity and therefore less price discovery is also leading firms to bidding “made up” prices to buy debt cheaply (e.g. bidding $0.40 when fair price is more like $0.65).

We also note that there is the potential for regulatory changes as a result of concerns around liquidity (and on the back of the Third Avenue lock-up in late 2015). While these regulatory changes have not yet been finalised, managers believe the SEC is concerned about three areas: trading during exceptionally volatile periods; liquidity and redemption issues with some ETFs; and highly leveraged ETFs.

The implications of this reduced liquidity and heightened volatility will vary depending on the manager and strategy, however several managers are in the process of reviewing their capacity constraints on the basis of reduced ability to implement positions, and some have already amended what they consider to be a reasonable restriction in terms of % that they can hold of a given bond (given the reduced ability to sell large pieces if necessary).

Overall, while most managers are not significantly impacted given the overall size of the high yield market, discussions regarding their approach to capacity management and position sizing have become much more frequent and also much more important than in the past.

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