High Yield Market Update

Continued strength in US and global economic growth ultimately drove markets higher in Q2 despite risks introduced by geopolitical events. Headline risks during the quarter ranged from privacy issues surrounding Facebook and technology companies in general, North Korean denuclearization, escalating trade wars and tariff impacts, Italian elections and populist movements, continued challenges for BREXIT, and global immigration policies. While markets reacted to these various headlines, a steady stream of positive economic data provided a floor to the volatility. Oil prices also provided a boost to the market with WTI Crude Oil ending Q2 up $9.21 (or 14.18%) to $74.15/bbl. Toward the end of the quarter, the Federal Open Market Committee (FOMC) implemented its second rate hike for 2018, citing a strengthening economic outlook. The US Dollar Index rose 5.00% and Treasuries ended the quarter with the 2-year up 25 basis points (bps) to 2.53% and the 10-year higher by 11bps to 2.85% as the yield curve continued to flatten.

The technical trends seen in Q1 remained intact during Q2. Loan funds saw further inflows of $7.7bn, while high yield mutual funds saw outflows of $4.5bn, as tracked by Lipper and reported by Barclays. High yield negative net supply created a positive technical as bond new issuance ticked lower to $47.6bn, offset by $79.8bn of bond redemptions, leaving net supply at -$32.2bn for the period. The percentage of the market trading at distressed levels (below 70% of par) ended Q2 at 2.1%; the comparable figure for the loan market (below 80% of par) was 2.3%, per JP Morgan. The par-weighted twelve-month high yield bond default rate inched lower to 1.25% at quarter-end, per BofA Merrill Lynch. Excluding commodities, the default rate was 1.17%.

The ICE BofAML US High Yield Index returned 1.0% in Q2, ending the period with an average price of 98.05, a 0.17 point decrease from the prior quarter. Credit spreads tightened by 17 bps to 361 bps and the yield-to-worst (YTW) was higher by 0.01% to 6.39%. High Yield outperformed investment grade corporates, as represented by the ICE BofAML US Corporate Index's -0.94% quarterly return, but underperformed small cap equities, as represented by the Russell 2000's 7.75% return, and large cap equities, as represented by the S&P 500's 3.43% quarterly return. In High Yield, the Double-B, Single-B and Triple-C sub-indices returned -0.12%, 1.52% and 3.58%, respectively. By sector, the top performer was Telecommunications, which delivered a 3.08% return, while Automotive was the bottom-performing sector, posting a -3.44% return.

Portfolio Performance

Portfolios managed according to our Unconstrained **Broad High Yield Market Strategy** (BHYM) underperformed the benchmark in Q2. By risk type, security selection was a source of under-performance while allocation had a muted impact. Weaker security selection and an underweight to the top-performing most speculative, equity-like part of the market drove under-performance although this was mostly due to not owning some of the most speculative names which rallied during the period. The underperformance was partially offset by security selection within the shortest duration segment of the market and an underweight to the better-quality, more rate sensitive part of the market. By sector, an underweight to speculative Energy and Telecom was a source of underperformance, partially offset by strong selection in Automotive and Basic Industry.

On a representative basis, the largest positive contributor was Bonanza Creek Energy (BCEI), which was among last quarter's largest bottom contributors and rallied during Q2 along with the upward move in oil and quarterly results in line with expectations. Last quarter's top contributor, Xerium Technologies Inc. (XRM) 9.5% notes due 2021 was among the top contributors in Q2, continuing to trade up following an announced strategic asset review which includes a possible sale of the company. Again the largest negative contributor, Rex Energy Corp (REXX) 8% notes due 2020 declined following a company-initiated prepackaged restructuring and the position was liquidated.

Broad High Yield Market Strategy: Performance

	SKY Harbor BHYM Strategy Performance			
	Gross of Fees	Net of Fees	ICE BofAML US HY Index	Alpha[1]
April 2018	0.67	0.65	0.67	0.01
May 2018	-0.05	-0.07	-0.02	-0.03
June 2018	0.18	0.16	0.35	-0.16
Q2 2018	0.80	0.73	1.00	-0.19
Year to Date 2018	0.03	-0.13	0.08	-0.05
Last 12 Months	2.98	2.67	2.53	0.45
Three Years (annl)	5.47	5.14	5.55	-0.08
SI Return (annl)	7.55	7.22	7.49	0.06

1 Based on gross of fees. Fees disclosed in SKY Harbor Form ADV, Part 2.
SI=Since Inception. Broad High Yield Market Composite inception date: 9/30/11.
Data displayed may not sum due to rounding.

Although concerns over rising interest rates continued into the second quarter and created some headwinds for fixed income investors, it was an income-driven quarter for SKY Harbor's Unconstrained **Short Duration High Yield Strategy** (SDHY) portfolios, which captured more than 90% of the broader US high yield market return (as defined by the ICE BofAML US High Yield Index) while experiencing lower volatility. All sectors were positive for the quarter with Consumer Goods and Telecom leading while Retail and Automotive lagged. Generally, the most speculative securities (yielding in excess of 9%) and lower quality led, with Triple-C securities outperforming Single-Bs and Double-Bs.

On a representative basis, at quarter-end our SDHY portfolios had a YTW of 5.48% (86% of the broad market yield). Exclusive of cash, the average coupon was 6.58% vs. the market average of 6.25% and the duration-to-worst was 2.1 (or 51% of the broad market). Holdings (303 issues, representing 225 issuers) comprised 36% bonds with maturities of less than three years and 64% in longer maturities but trading to expected early take-outs inside this three-year period. This overweight to the latter group continues to show that we find greater value in the yield-to-call opportunities. Nevertheless, we do value the relative price stability the short maturity group can offer in volatile periods in the market.

Short Duration High Yield Strategy: Performance

	SKY Harbor SDHY Strategy Performance				Annualized Daily Volatility[2]		
	Gross of Fees	High Yield Market[1]	Market Capture[2]	Net of Fees	SKY SDHY Strategy	High Yield Market[1]	Relative Volatility
April 2018	0.55	0.67	83%	0.53	1.3	2.9	45%
May 2018	0.19	-0.02	NM	0.17	0.8	1.5	54%
June 2018	0.18	0.35	53%	0.15	0.8	1.8	47%
Q2 2018	0.93	1.00	94%	0.85	1.0	2.1	47%
Year to Date 2018	1.37	0.08	NM	1.19	1.5	2.7	55%
Last 12 Months	3.33	2.53	132%	2.97	1.2	2.3	54%
Three Years (annl)	3.81	5.55	69%	3.45	2.0	4.1	51%
Since Inception (annl)	4.43	6.66	66%	4.04	1.9	3.5	54%

1. The Short Duration High Yield strategy is not a benchmarked strategy. The HY Market index shown (ICE BofAML US HY Index) is provided solely as a relative market indicator.
2. Based on gross of fees. Fees disclosed in SKY Harbor Form ADV, Part 2.
Short Duration High Yield Composite Inception date: 10/31/11

Outlook

Despite geopolitical-related volatility, we maintain a relatively consistent view of high yield market risks and opportunities. We are continuing to gradually move our positioning to a less aggressive underweight to interest-related risks as volatility allows attractive entry points. Our greatest conviction remains around strong corporate fundamentals with additional support from the strong technicals associated with lower issuance on the bond side and strong investor demand on the loan side. We have acknowledged that valuations are only fair by historical standards and rising rates present potential risks, but believe high yield could have further spread compression as markets return focus to strength of the US economy and company growth trends. We expect returns to benefit from the market income opportunity and below-average default losses and expect risks outside the high yield market to generally remain In balance (e.g., trade wars do not escalate, etc.) although shift in relative weights in investors' minds.

Our Broad High Yield Market (BHYM) portfolios remain underweight the better-quality, more rate-sensitive segment of the market and this positioning has been a source of positive relative performance throughout most of the year. However, we have been and we will continue to be opportunistic purchasers of better-quality, rate-sensitive risk that typically reprices during rate-related volatility. We also continue to look for opportunities to add income through credit picking among companies with improving earnings. Our BHYM portfolios are more concentrated in high conviction holdings than has been the case in recent years and are benefiting from outperformance by this part of the portfolio generally.

While corporate fundamentals are strong, we believe we are generally not being paid to take "equity-like" risk at current market levels due to the underlying secular and/or cyclical

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Portfolio Characteristics

Representative Broad High Yield Market Portfolio

Characteristics	Portfolio[1]	HY Market
Avg Years to Maturity	5.9	6.1
Yield to Worst	6.38%	6.39%
Current Yield	6.83%	6.45%
Duration to Worst	3.8	4.1
OAS	358	361
Avg Coupon	6.84%	6.32%
Number of Issuers	253	884
Number of Issues	308	1878
Average ML Rating	B2	B1
Average Price	100.1	98.1

Distribution by ML Rating	Portfolio[1]	HY Market
A Holdings	0.0%	0.0%
BBB Holdings	0.1%	0.0%
BB Holdings	27.6%	46.4%
B Holdings	56.0%	42.0%
CCC or Under	16.3%	11.6%

Distribution by Issue Size	Portfolio[1]	HY Market
0 - 250M	7.0%	1.5%
250 - 500M	37.5%	28.8%
500 - 750M	19.8%	20.7%
750 - 1000M	9.7%	15.8%
1000+M	26.1%	33.2%

Distribution by Sector	Portfolio[1]	HY Market	SKY as % of HY Market
Basic Industry	16.6%	11.8%	141%
Energy	10.1%	15.6%	65%
Services	9.6%	5.5%	173%
Technology & Electronics	9.3%	5.7%	162%
Capital Goods	9.0%	5.3%	169%
Healthcare	8.8%	10.2%	86%
Media	8.3%	11.1%	75%
Telecommunications	6.6%	9.2%	72%
Leisure	4.2%	4.3%	98%
Automotive	4.0%	1.8%	229%
Financial Services	3.0%	4.1%	73%
Retail	2.3%	4.3%	55%
Consumer Goods	1.6%	2.7%	58%
Utility	1.6%	2.4%	66%
Real Estate	1.5%	0.9%	161%
Transportation	1.3%	0.9%	143%
Banking	1.2%	3.1%	38%
Insurance	0.9%	1.0%	91%

Top 5 Holdings by Weight	BofA ML Rating	Issue Size ($mil)	Current Price	BofA ML Industry	Duration to Worst	Yield to Worst (%)	% of Portfolio
Ahern Rentals Inc. 7.375% 15-May-2023	B3	550.0	97.50	Services	3.97	8.00	1.29
QUAD/GRAPHICS 7.000% 01-May-2022	B2	300.0	102.13	Media	3.30	6.36	1.14
Universal Hospital Services 7.625% 15-Aug-2020	B3	645.0	99.75	Healthcare	1.87	7.75	1.04
Xerium Technologies Inc. 9.500% 15-Aug-2021	B2	479.5	105.50	Basic Industry	0.12	3.21	1.03
Solera LLC 10.500% 01-Mar-2024	CCC1	1,730.0	111.13	Technology & Electronics	0.63	5.18	1.02

Representative Short Duration High Yield Portfolio

Characteristics	Portfolio[1]	HY Market[2]	SD Universe[3]
Avg Years to Maturity	3.5	6.1	3.5
Yield to Worst	5.48%	6.39%	5.46%
Current Yield	6.46%	6.45%	6.06%
Duration to Worst	2.1	4.1	2.4
OAS	286	361	283
Avg Coupon	6.58%	6.32%	6.09%
Number of Issuers	225	884	406
Number of Issues	303	1878	655
Average ML Rating	B1	B1	BB3
Average Price	101.84	98.05	100.45

Distribution by ML Rating	Portfolio[1]	HY Market[2]	SD Universe[3]
A Holdings	0.0%	0.0%	0.0%
BBB Holdings	1.0%	0.0%	0.0%
BB Holdings	32.2%	46.4%	49.7%
B Holdings	57.6%	42.0%	50.3%
CCC or Under	9.2%	11.6%	0.0%

Distribution by Issue Size	Portfolio[1]	HY Market[2]	SD Universe[3]
0 - 250M	8.7%	1.5%	0.0%
250 - 500M	36.1%	28.7%	23.9%
500 - 750M	20.4%	20.6%	24.8%
750 - 1000M	11.5%	15.7%	12.3%
1000+M	23.2%	33.4%	39.0%

Distribution by Sector	Portfolio[1]	HY Market[2]	SD Universe[3]
Basic Industry	17.4%	11.8%	12.3%
Energy	12.4%	15.6%	15.7%
Media	11.2%	11.1%	12.0%
Healthcare	10.8%	10.2%	10.1%
Telecommunications	7.4%	9.2%	8.1%
Capital Goods	7.0%	5.3%	6.3%
Technology & Electronics	6.6%	5.7%	4.7%
Financial Services	5.4%	4.1%	7.4%
Services	5.4%	5.5%	4.7%
Leisure	3.6%	4.3%	3.5%
Automotive	3.1%	1.8%	1.6%
Transportation	3.1%	0.9%	1.7%
Retail	2.1%	4.3%	3.2%
Consumer Goods	1.5%	2.7%	1.9%
Real Estate	1.3%	0.9%	1.1%
Utility	1.0%	2.4%	2.3%
Banking	0.8%	3.1%	2.7%
Insurance	0.0%	1.0%	0.7%

Top 5 Holdings by Weight	BofA ML Rating	Issue Size ($mil)	Current Price	BofA ML Industry	Duration to Worst	Yield to Worst (%)	% of Portfolio
Sprint Communications Inc. 7.000% 15-Aug-2020	B2	1,500.0	103.50	Telecommunications	1.91	5.23	0.97
HCA Healthcare Inc 6.250% 15-Feb-2021	BB3	1,000.0	103.75	Healthcare	2.35	4.71	0.81
CSC Holdings LLC 6.750% 15-Nov-2021	B2	1,000.0	104.75	Media	2.98	5.19	0.74
DISH DBS Corporation 6.750% 01-Jun-2021	B1	2,000.0	100.00	Media	2.60	6.70	0.70
Sprint Corporation 7.250% 15-Sep-2021	B2	2,250.0	104.00	Telecommunications	2.79	5.86	0.69

1 Exclusive of Cash. 2,3 The Short Duration High Yield strategy is not a benchmarked product; the HY Indices shown are provided solely as a relative market indicators.
This comparison of selected characteristics of representative SKY Harbor portfolios on or about June 30, 2018 is provided for illustrative purposes only and is subject to change without notice in accordance with the strategies' stated objectives and the sole discretion of SKY Harbor's portfolio management team.
Source: SKY Harbor, FactSet, Ice BofAML US High Yield indexes H0A0 (HY Market) and JVC4 (SD Universe).

Outlook *(cont.)*

changes that much of the remaining higher-yielding part of the market faces. Based on our view of risks and valuations across the market, we continue to believe Single-B rated credit offers the best opportunity for attractive returns through credit picking.

Turning to our Short Duration High Yield strategy, we continue to believe these SDHY portfolios offer an attractive yield per unit of duration and are well positioned to take advantage of any potential volatility or curve repricing associated with more aggressive rate assumptions. In our view, natural turnover, created by calls, tender and maturities, should be high considering the large amount of front-end maturities and expected near-term calls held in the portfolio, which will allow us to continue to optimize the portfolios as the market environment evolves.

For more information, contact SKY Harbor Capital Management, LLC at +1 203 769 8800 or email info@skyhcm.com