

High Yield Market Update

During the quarter risk assets were heavily influenced by geopolitical events and despite a selloff in May, Q2 produced another strong quarterly return. The period was dominated by the breakdown in US-China trade negotiations and escalating actions. Economic data continued to deteriorate throughout the quarter and the market seemed to be pricing in a higher probability of near-term recession. However, global central banks acknowledged weaker fundamentals and indicated more accommodation could be necessary sooner rather than later. While a more dovish Fed turned markets positive, oil could not rally enough and closed with WTI Crude down \$1.67 (or -2.87%) to \$58.47/bbl, resulting in Energy being Q2's only negative sector. The US Dollar Index declined 1.19% and Treasuries ended the quarter with the 2-year down 53 basis points (bps) to 1.76% and the 10-year lower by 42 bps to 2.00% as the yield curve flattened.

Technicals were neutral in Q2 as high yield funds and ETFs had outflows of \$0.3bn while loan funds saw outflows of \$9.5bn, as tracked by Lipper and reported by Barclays. Net supply was positive for the quarter as bond new issuance picked up, pricing \$69.7bn in the quarter, offset by \$46.6bn of bond redemptions, leaving net supply at \$23.1bn for the period, per Barclays. The

percentage of the market trading at distressed (below 70% of par) ended Q2 at 4.3%; the comparable figure for the loan market (below 80% of par) was 3.2%, per JP Morgan. The par-weighted twelve-month high yield bond default rate increased to 0.89% at quarter-end, per BofA Merrill Lynch. Excluding commodities, the default rate was 0.50%.

The ICE BofAML US High Yield Index returned 2.57% in Q2, ending the period with an average price of 98.88, a 1.15-point increase from the prior quarter. Credit spreads widened by 8 bps to 406 bps and the yield-to-worst (YTW) was lower by 0.53% to 6.04%. High yield outperformed small cap equities, represented by the Russell 2000's 2.09% return but underperformed investment grade corporates, as represented by the ICE BofAML US Corporate Index's 4.53% quarterly return, as well as large cap equities, as represented by the S&P 500's 4.30% return. In high yield, the Double-B, Single-B and Triple-C sub-indices returned 3.16%, 2.42% and 0.65%, respectively. Most sectors generated positive returns for the quarter: the top performer was Insurance, which saw an 4.74% return, while Energy was the bottom-performing sector, posting a -0.83% return, the only negative sector for the quarter.

Portfolio Performance

Portfolios managed according to our Unconstrained **Broad High Yield Market Strategy** (BHYM) posted strong returns during Q2 but modestly underperformed the benchmark. By risk type, security selection was a source of outperformance while allocation was a source of underperformance. Selection within the Single-B like part of the market (yielding 6-7%) was weak as compared to the market although the impact was moderated by strong selection within the modestly higher yielding segment of the market (yielding 7-8%) that includes some lower rated credit. By sector, weaker selection in Basic Industry and Retail were sources of underperformance but were offset by a significant underweight to bottom-performing Energy and strong selection in Healthcare.

On a representative basis, the top contributor to BHYM returns was Townsquare Media (TSQ) 6.5% notes due 2023, which traded up on strong Q1 earnings. Last quarter's top contributor, Ahern Rentals (AHEREN) 7.375% notes due 2023, was among bottom contributors in Q2 as riskier credits lagged the market. The largest bottom contributor was Exela Intermediate 10% notes due 2023, which traded down sharply during the quarter on Q1 results that were below expectations and soft Q2 guidance. Last quarter's

largest bottom contributor, Weight Watchers International (WTW) 8.625% notes due 2025, was among bottom contributors to returns in Q2 although the issue has traded up somewhat post quarter.

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 2019	1.30	1.27	1.40	-0.10
May 2019	-1.01	-1.04	-1.27	0.26
June 2019	2.09	2.07	2.45	-0.36
Q2 2019	2.37	2.30	2.57	-0.19
Year to Date 2019	9.09	8.92	10.16	-1.06
Last 12 Months	6.72	6.40	7.58	-0.86
Three Years (annl)	7.57	7.24	7.54	0.03
SI Return (annl)	7.45	7.11	7.50	-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.

SKY Harbor's Unconstrained **Short Duration High Yield Strategy** (SDHY) portfolios posted solid positive returns during Q2, capturing over 50% of the broader US high yield market return (as measured by the ICE BofAML US High Yield Index). A duration shorter than the broad high yield market helped to reduce volatility during the quarter but also limited the full upward price capture of the broader high yield market. Generally, longer duration outperformed shorter duration, more defensive securities and more speculative securities. All sectors posted positive returns for the quarter except for Energy, which was modestly negative. By rating, higher quality led, with Double-Bs outperforming Single-Bs and Triple-Cs.

On a representative basis, at quarter-end our SDHY portfolios had a YTW of 4.43% (73% of the broad market yield). Exclusive of cash, the average coupon was 6.29% vs. the market average of 6.38% and the duration-to-worst was 1.5 (or 44% of the broad market). Holdings (323 issues, representing 225 issuers) comprised 45% bonds with maturities of less than three years and 55% in longer maturities that are 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 2019	0.81	1.40	58%	0.78	0.6	1.5	44%
May 2019	-0.50	-1.27	39%	-0.53	1.5	2.9	50%
June 2019	1.25	2.45	51%	1.23	1.3	2.7	46%
Q2 2019	1.56	2.57	61%	1.48	1.3	2.7	48%
Year to Date 2019	6.29	10.16	62%	6.12	1.7	3.3	52%
Last 12 Months	5.80	7.58	76%	5.45	1.8	3.3	54%
Three Years (annl)	5.47	7.54	73%	5.11	1.5	2.9	53%
Since Inception (annl)	4.60	6.78	68%	4.22	1.9	3.4	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

While trade discussions, geopolitical risks and China are likely to continue to impact risk premiums, overall high yield fundamentals and technicals remain generally supportive, in our view. We see growing concern around second quarter earnings and some increased concerns around the timing of the next cyclical downturn. With the market's recent adjustment to lower Treasury rates and somewhat weakening US manufacturing and other indicators of economic activity, we see high yield spreads as fairly valued and expect credit selection to drive returns on a go-forward basis. Overall, we continue to believe the high yield market can provide attractive full-year returns with some elevated volatility.

Our Broad High Yield Market portfolios remain underweight the better-quality, more rate-sensitive segment of the market in favor of credit picking among the higher-yielding part of the market and an overweight to the defensive short duration parts of the market. We continue to use volatility and the primary market to reduce our current underweight to higher-rated longer duration bonds with a focus on those industry groups that are best positioned for sustainable growth in an aging

economic cycle. We had substantially reduced our exposure to US housing, the Energy sector and industries that have a high degree of sensitivity to Chinese growth although have recently added back some housing-related risk as lower rates have improved near-term affordability in a number of markets. Our BHYM portfolios remain 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. 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 the SDHY strategy, we believe our portfolios remain well positioned for the current market environment as they are capturing over 70% of the market yield with less than half of the market duration. We think the high current income combined with the typically defensive nature of the portfolio results in an attractive asset class better insulated from potential market volatility, pending resolution of geopolitical events. Natural turnover, created by calls, tender and maturities, will continue to allow us to optimize the portfolios as the market environment evolves.

Portfolio Characteristics

Representative Broad High Yield Market Portfolio

Characteristics	Portfolio ¹	HY Market	Distribution by Sector	Portfolio ¹	HY Market	SKY as % of HY Market	
Avg Years to Maturity	5.5	5.7	Media	13.2%	11.7%	113%	
Yield to Worst	5.82%	6.04%	Healthcare	12.6%	9.9%	126%	
Current Yield	6.72%	6.45%	Basic Industry	12.2%	10.5%	116%	
Duration to Worst	3.1	3.4	Services	11.4%	5.2%	221%	
OAS	378	406	Capital Goods	8.9%	6.0%	148%	
Avg Coupon	6.84%	6.38%	Technology & Electronics	8.1%	5.8%	140%	
Number of Issuers	144	847	Leisure	7.0%	4.9%	144%	
Number of Issues	174	1791	Telecommunications	4.3%	9.6%	45%	
Average ML Rating	B2	B1	Retail	4.2%	4.7%	88%	
Average Price	101.9	98.9	Energy	3.9%	14.2%	28%	
			Consumer Goods	3.9%	3.0%	132%	
			Insurance	2.2%	1.2%	185%	
			Financial Services	2.0%	4.2%	48%	
			Transportation	2.0%	1.0%	199%	
			Real Estate	1.7%	1.4%	118%	
			Automotive	1.3%	1.9%	66%	
			Banking	0.9%	2.5%	35%	
			Utility	0.2%	2.2%	10%	
Distribution by ML Rating	Portfolio ¹	HY Market					
A Holdings	0.0%	0.0%					
BBB Holdings	0.0%	0.0%					
BB Holdings	27.0%	48.4%					
B Holdings	55.7%	40.2%					
CCC or Under	17.3%	11.4%					
Distribution by Issue Size	Portfolio ¹	HY Market					
0 - 250M	9.4%	1.3%					
250 - 500M	39.8%	28.3%					
500 - 750M	14.9%	21.2%					
750 - 1000M	15.7%	15.8%					
1000+M	20.2%	33.4%					
Top 5 Holdings by Weight	BofA ML Rating	Issue Size (\$mil)	Current Price	BofA ML Industry	Duration to Worst	Yield to Worst (%)	% of Portfolio
Townsquare Media Inc. 6.500% 01-Apr-2023	B3	280.1	99.00	Media	3.22	6.96	2.30
Unisys Corporation 10.750% 15-Apr-2022	B1	440.0	110.50	Technology & Electronics	0.75	4.01	2.01
Bausch Health Companies 9.250% 01-Apr-2026	B3	1,500.0	111.75	Healthcare	2.39	6.06	2.01
QUAD/GRAPHICS 7.000% 01-May-2022	B2	243.5	101.50	Media	2.52	6.40	1.89
TMS International Corp 7.250% 15-Aug-2025	B3	250.0	96.75	Services	4.71	7.93	1.88

Representative Short Duration High Yield Portfolio

Characteristics	Portfolio ¹	HY Market ²	SD Universe ³	Distribution by Sector	Portfolio ¹	HY Market ²	SD Universe ³
Avg Years to Maturity	3.2	5.7	3.3	Media	13.8%	11.7%	11.7%
Yield to Worst	4.43%	6.04%	5.00%	Basic Industry	10.4%	10.5%	11.0%
Current Yield	6.14%	6.45%	6.01%	Healthcare	10.3%	9.9%	9.4%
Duration to Worst	1.5	3.4	1.9	Telecommunications	8.3%	9.6%	9.2%
OAS	244	406	307	Energy	6.5%	14.2%	13.7%
Avg Coupon	6.29%	6.38%	6.06%	Capital Goods	7.4%	6.0%	7.2%
Number of Issuers	225	847	409	Leisure	8.5%	4.9%	3.7%
Number of Issues	323	1791	660	Services	6.7%	5.2%	4.7%
Average Rating	B1	B1	BB3	Technology & Electronics	6.8%	5.8%	6.6%
Average Price	102.44	98.88	100.86	Financial Services	6.6%	4.2%	6.2%
				Transportation	3.0%	1.0%	2.1%
				Automotive	2.5%	1.9%	1.6%
				Retail	2.6%	4.7%	3.9%
				Consumer Goods	2.3%	3.0%	2.2%
				Real Estate	1.8%	1.4%	2.1%
				Utility	1.0%	2.2%	1.6%
				Banking	0.7%	2.5%	1.9%
				Other	0.4%	0.0%	0.0%
				Insurance	0.4%	1.2%	1.2%
Distribution by Rating	Portfolio ¹	HY Market ²	SD Universe ³				
A Holdings	0.0%	0.0%	0.0%				
BBB Holdings	3.0%	0.0%	0.0%				
BB Holdings	44.4%	48.4%	53.5%				
B Holdings	45.8%	40.2%	46.5%				
CCC or Under	6.8%	11.4%	0.0%				
Distribution by Issue Size	Portfolio ¹	HY Market ²	SD Universe ³				
0 - 250M	5.3%	1.3%	0.0%				
250 - 500M	30.6%	28.2%	23.0%				
500 - 750M	20.7%	21.2%	26.9%				
750 - 1000M	13.5%	15.8%	12.8%				
1000+M	29.9%	33.6%	37.3%				
Top 5 Holdings by Weight	Average Rating	Issue Size (\$mil)	Current Price	BofA ML Industry	Duration to Worst	Yield to Worst (%)	% of Portfolio
Reynolds Group Issuer LLC. 5.750% 15-Oct-2020	B1	3,236.8	100.25	Capital Goods	0.08	2.71	0.92
Sprint Corporation 7.250% 15-Sep-2021	B2	2,250.0	106.25	Telecommunications	2.00	4.25	0.88
Park Aerospace Holdings 5.250% 15-Aug-2022	BBB3	2,050.0	105.50	Financial Services	2.83	3.35	0.75
HCA Healthcare Inc 6.250% 15-Feb-2021	BB3	1,000.0	104.75	Healthcare	1.51	3.22	0.72
International Game Technology 6.25% 15-Feb-2022	BB2	1,500.0	105.63	Leisure	1.95	3.47	0.70

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, 2019 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).

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