

High Yield Market Update

Risk assets moved higher throughout the quarter despite ongoing tensions surrounding global trade translating to the potential for reduced global growth. The High Yield market posted its strongest quarter in over a year, benefiting from the continuation of strong corporate growth and positive US economic data while remaining resilient against rising interest rates. At the end of the quarter, the Federal Open Market Committee (FOMC) implemented a third rate hike for 2018, reaffirming its positive economic outlook. Oil prices were volatile throughout the quarter and WTI Crude Oil ended Q3 down \$0.90 (or -1.21%) to \$73.25/bbl. The US Dollar Index rose 0.70% and Treasuries ended the quarter with the 2-year up 29 basis points (bps) to 2.82% and the 10-year higher by 21bps to 3.06% as the yield curve continued to flatten.

Technical were mixed in Q3 as loan funds saw inflows of \$3.6bn while high yield mutual funds had outflows of \$1.7bn. Net supply was positive as bond new issuance ticked higher to \$60.6bn, offset by only \$46.6bn of bond redemptions, leaving net supply at \$14.0bn for the period, as tracked by Lipper and reported by Barclays. The percentage of the market trading at distressed levels

(below 70% of par) ended Q3 at 1.7%; the comparable figure for the loan market (below 80% of par) was 2.0%, per JP Morgan. The par-weighted twelve-month high yield bond default rate inched lower to 1.08% at quarter-end, per BofA Merrill Lynch. Excluding commodities, the default rate was 0.95%.

The ICE BofAML US High Yield Index returned 2.44% in Q3, ending the period with an average price of 98.56, a 0.51 point increase from the prior quarter. Credit spreads tightened by 38 bps to 323 bps and the yield-to-worst (YTW) was lower by 0.17% to 6.22%. High Yield outperformed investment grade corporates, as represented by the ICE BofAML US Corporate Index's 0.96% quarterly return, but underperformed small cap equities, as represented by the Russell 2000's 3.57% return, and large cap equities, as represented by the S&P 500's 7.71% quarterly return. In High Yield, the Double-B, Single-B and Triple-C sub-indices returned 2.36%, 2.41% and 2.85%, respectively. All sectors generated positive returns for the quarter: the top performer was Healthcare, which delivered a 3.41% return, while Retail was the bottom-performing sector, posting a 1.06% return.

Portfolio Performance

Portfolios managed according to our Unconstrained **Broad High Yield Market Strategy** (BHYM) modestly underperformed the benchmark in Q3. By risk type, both allocation and security selection were sources of underperformance. Weaker security selection in the most speculative part of the market and the intermediate-quality part of the market (yielding between 6%-7%) drove underperformance, offset by strong selection in the short duration part of the market and an underweight to the lower-performing most rate-sensitive part of the market. By sector, strong selection in Media and Retail were sources of outperformance but were offset by weaker selection in speculative Energy and, to some extent, Basic Industry.

On a representative basis, the largest positive contributor was Townsquare Media, Inc. (TSQ) 6.5% notes due 2023, which traded up during the quarter on positive Q2 earnings and an announced asset sale. Last quarter's top contributor, Bonanza Creek Energy, Inc. (BCEI) was this quarter's largest bottom contributor, having faced headwinds in Q3 surrounding proposed increased drilling regulation in Colorado. Last quarter's bottom contributor, Rex Energy Corp. (REXX) 8% notes due 2020 was liquidated in Q2.

Broad High Yield Market Strategy: Performance

	SKY Harbor BHYM Strategy Performance			
	Gross of Fees	Net of Fees	ICE BofAML US HY Index	Alpha ¹
July 2018	0.97	0.94	1.12	-0.15
August 2018	0.71	0.69	0.72	-0.01
September 2018	0.56	0.54	0.58	-0.02
Q3 2018	2.26	2.18	2.44	-0.18
Year to Date 2018	2.29	2.05	2.52	-0.23
Last 12 Months	3.21	2.89	2.94	0.27
Three Years (annl)	7.72	7.38	8.19	-0.48
SI Return (annl)	7.61	7.28	7.58	0.03

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.

It was a positive quarter for SKY Harbor's Unconstrained **Short Duration High Yield Strategy** (SDHY) portfolios, which captured nearly 80% of the broader US high yield market return (as defined by the ICE BofAML US High Yield Index) and experienced lower volatility. By risk type (defined by yield and duration to worst), generally longer durations returned more relative to shorter durations. All sectors were positive for the quarter with Services and Media leading and Automotive and Leisure lagging. By rating, the dispersion among groups was minimal, with Single-Bs narrowly outperforming Triple-Cs and Double-Bs.

On a representative basis, at quarter-end our SDHY portfolios had a YTW of 5.29% (85% of the broad market yield). Exclusive of cash, the average coupon was 6.61% vs. the market average of 6.35% and the duration-to-worst was 1.9 (or 51% of the broad market). Holdings (255 issues, representing 201 issuers) comprised 30% bonds with maturities of less than three years and 70% 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
July 2018	0.76	1.12	68%	0.73	0.8	1.7	48%
August 2018	0.58	0.72	80%	0.55	0.6	1.2	47%
September 2018	0.51	0.58	87%	0.48	0.4	0.9	47%
Q3 2018	1.86	2.44	76%	1.78	0.6	1.3	48%
Year to Date 2018	3.25	2.52	129%	2.99	1.3	2.5	54%
Last 12 Months	3.91	2.94	133%	3.55	1.2	2.3	54%
Three Years (annl)	5.33	8.19	65%	4.97	1.9	3.9	50%
Since Inception (annl)	4.54	6.78	67%	4.16	1.8	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

Our view of high yield market risks and opportunities is largely unchanged. Our greatest conviction remains around strong corporate fundamentals with additional support from the strong technicals associated with low 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 investors focus on the strength of the US economy and positive corporate profitability. We expect returns to benefit from the market income opportunity and below-average default losses and expect investors' perception of risk to remain generally unchanged (e.g., recession risks do not rise, etc.). As a result, our positioning has not substantially changed over the quarter.

Our Broad High Yield Market portfolios remain underweight the better-quality, more rate-sensitive segment of the market. We are continuing to gradually move our positioning to a less aggressive underweight to interest rate-related risks as volatility allows attractive entry points. We continue to look for opportunities to add income through credit picking among

companies with improving earnings. Our Broad High Yield Market 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. 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 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 our SDHY portfolios are well positioned to take advantage of any potential volatility or curve repricing associated with more aggressive rate assumptions. 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 portfolio as the market environment evolves.

SKY HARBOR CAPITAL MANAGEMENT

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	5.8	6.0	Basic Industry	14.9%	11.4%	130%	
Yield to Worst	6.13%	6.22%	Technology & Electronics	10.5%	5.8%	181%	
Current Yield	6.81%	6.44%	Energy	10.2%	15.8%	65%	
Duration to Worst	3.6	3.9	Capital Goods	9.9%	5.3%	187%	
OAS	313	323	Services	9.8%	5.3%	184%	
Avg Coupon	6.87%	6.35%	Healthcare	9.7%	11.0%	89%	
Number of Issuers	238	883	Media	8.5%	11.0%	77%	
Number of Issues	294	1866	Telecommunications	6.6%	9.2%	72%	
Average ML Rating	B2	B1	Leisure	3.5%	4.6%	76%	
Average Price	100.9	98.6	Automotive	2.9%	1.8%	168%	
			Retail	2.7%	4.2%	65%	
			Financial Services	2.6%	4.2%	62%	
			Consumer Goods	2.4%	2.9%	83%	
			Transportation	1.4%	0.9%	161%	
			Real Estate	1.4%	0.8%	183%	
			Banking	1.2%	2.4%	51%	
			Utility	0.8%	2.4%	32%	
			Insurance	0.8%	1.1%	72%	
Distribution by ML Rating	Portfolio ¹	HY Market					
A Holdings	0.0%	0.0%					
BBB Holdings	0.4%	0.0%					
BB Holdings	29.6%	45.7%					
B Holdings	53.9%	41.5%					
CCC or Under	16.1%	12.8%					
Distribution by Issue Size	Portfolio ¹	HY Market					
0 - 250M	5.9%	1.5%					
250 - 500M	37.0%	28.8%					
500 - 750M	19.6%	20.7%					
750 - 1000M	10.0%	15.9%					
1000+M	27.5%	33.2%					
Top 5 Holdings by Weight	BofA ML Rating	Issue Size (\$mil)	Current Price	BofA ML Industry	Duration to Worst	Yield to Worst (%)	% of Portfolio
American Axle & Manufacturing 6.500% 01-Apr-2027	B2	496.0	98.88	Automotive	6.44	6.66	1.34
Ahern Rentals Inc. 7.375% 15-May-2023	B3	550.0	99.25	Services	3.74	7.76	1.30
CPG Merger Sub LLC 8.000% 01-Oct-2021	CCC2	315.0	100.50	Basic Industry	0.95	6.82	1.19
QUAD/GRAPHICS 7.000% 01-May-2022	B2	300.0	101.00	Media	3.05	6.67	1.12
Unisys Corporation 10.750% 15-Apr-2022	B1	440.0	112.63	Technology & Electronics	2.15	5.41	1.01

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	3.5	6.0	3.4	Basic Industry	17.6%	11.4%	12.1%
Yield to Worst	5.29%	6.22%	5.23%	Energy	11.6%	15.8%	15.7%
Current Yield	6.48%	6.44%	6.05%	Media	11.1%	11.0%	11.4%
Duration to Worst	1.9	3.9	2.3	Healthcare	10.0%	11.0%	9.9%
OAS	246	323	239	Services	8.1%	5.3%	5.3%
Avg Coupon	6.61%	6.35%	6.10%	Telecommunications	7.7%	9.2%	7.9%
Number of Issuers	201	883	406	Capital Goods	7.6%	5.3%	6.6%
Number of Issues	255	1866	648	Technology & Electronics	6.0%	5.8%	5.4%
Average ML Rating	B1	B1	BB3	Financial Services	5.2%	4.2%	7.0%
Average Price	102.13	98.56	100.88	Leisure	4.4%	4.6%	3.8%
				Transportation	2.6%	0.9%	1.7%
				Automotive	2.2%	1.8%	1.7%
				Real Estate	1.9%	0.8%	1.0%
				Consumer Goods	1.5%	2.9%	1.8%
				Retail	1.1%	4.2%	3.4%
				Utility	1.1%	2.4%	2.3%
				Banking	0.4%	2.4%	2.3%
				Insurance	0.0%	1.1%	1.0%
Distribution by ML Rating	Portfolio ¹	HY Market ²	SD Universe ³				
A Holdings	0.0%	0.0%	0.0%				
BBB Holdings	0.6%	0.0%	0.0%				
BB Holdings	30.6%	45.7%	50.3%				
B Holdings	58.7%	41.5%	49.7%				
CCC or Under	10.2%	12.8%	0.0%				
Distribution by Issue Size	Portfolio ¹	HY Market ²	SD Universe ³				
0 - 250M	7.2%	1.5%	0.0%				
250 - 500M	36.1%	28.6%	22.8%				
500 - 750M	21.7%	20.5%	25.5%				
750 - 1000M	13.5%	15.8%	12.6%				
1000+M	21.4%	33.6%	39.1%				
Top 5 Holdings by Weight	ICE BofAML Rating	Issue Size (\$mil)	Current Price	ICE BofAML Industry	Duration to Worst	Yield to Worst (%)	% of Portfolio
CSC Holdings LLC 6.750% 15-Nov-2021	B2	1,000.0	105.25	Media	2.74	4.87	0.89
Sprint Corporation 7.250% 15-Sep-2021	B2	2,250.0	105.75	Telecommunications	2.64	5.13	0.82
HudBay Minerals Inc 7.250% 15-Jan-2023	B2	400.0	103.25	Basic Industry	2.47	6.15	0.75
Altice Luxembourg S.A. 7.750% 15-May-2022	B3	2,587.7	97.38	Media	3.06	8.69	0.74
Lin Television Corporation 5.875% 15-Nov-2022	B2	400.0	101.87	Media	1.93	5.12	0.71

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 September 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 HOA0 (HY Market) and JVC4 (SD Universe).

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