

High Yield Market Update

Several high-profile corporate profit warnings, trade war tensions, the fear of slowing global growth and concerns over a potential Fed misstep created a “perfect storm” in Q4’18, resulting in a sharp selloff of risk assets even through the (typically quiet) late-December holiday period. By the time selling pressure subsided, the US High Yield market had widened 210 basis points (bps). The move was remarkable, as a quarterly backup in spreads greater than 200 bps has happened only seven times in the last 20 years, with the last occurring in Q3’11. Oil, which has meaningful ramifications for the High Yield market, was hit particularly hard this quarter with WTI Crude down \$27.84 (or -38.01%) to \$45.41/bbl. The US Dollar Index rose 1.09% and Treasuries ended the quarter with the 2-year down 31 bps to 2.51% and the 10-year lower by 37 bps to 2.69% as the yield curve continued to flatten.

Market technicals were cushioned by negative net supply in the face of substantial investor withdrawals. Loan and high yield funds saw outflows in Q4 of \$13.4bn and \$18.1bn, respectively, as tracked by Lipper and reported by Barclays. On the positive, net supply remained negative as bond new issuance was significantly lower, pricing only \$18.3bn in the quarter, offset by \$43.2bn of bond redemptions, leaving net supply at -\$24.9bn for the period,

per Barclays. Remarkably, no new bond issues were priced in the month of December. The percentage of the market trading at distressed levels (below 70% of par) ended Q4 at 4.9%; the comparable figure for the loan market (below 80% of par) was 3.3%, per JP Morgan. The par-weighted twelve-month high yield bond default rate lowered to 0.88% at quarter-end, per BofA Merrill Lynch. Excluding commodities, the default rate was 1.03%.

The ICE BofAML US High Yield Index returned -4.67% in Q4, ending the period with an average price of 92.28, a 6.28 point decrease from the prior quarter. Credit spreads widened by 210 bps to 533 bps and the yield-to-worst (YTW) was higher by 1.72% to 7.93%. High Yield underperformed investment grade corporates, as represented by the ICE BofAML US Corporate Index’s -0.06% quarterly return, but outperformed small cap equities, represented by the Russell 2000’s -20.21% return, and large cap equities, as represented by the S&P 500’s -13.52% return. In High Yield, the Double-B, Single-B and Triple-C sub-indices returned -2.99%, -4.85% and -10.35%, respectively. All sectors generated negative returns for the quarter: the top performer was Utility, which saw a -1.35% return, while Energy was the bottom-performing sector, posting a -9.74% return.

Portfolio Performance

Portfolios managed according to our Unconstrained **Broad High Yield Market Strategy** (BHYM) outperformed the benchmark in Q4. By risk type, allocation was a source of outperformance while security selection was a source of underperformance. The primary driver of outperformance was an underweight to the most speculative part of the market (yielding in excess of 9%) which was the most penalized during the selloff. This was partially offset by weaker selection in the intermediate risk and most speculative parts of the market. By sector, an underweight to bottom-performing Energy and strong selection in Healthcare were sources of outperformance, partially offset by weaker selection in Services and Energy.

On a representative basis, the largest positive contributor to BHYM portfolio returns was Agiliti Health Inc. (UHOS) 7.625% notes due 2020, which was acquired by another company that is refinancing the bonds. Last quarter’s top contributor, Townsquare Media Inc. (TSQ) 6.5% notes due 2023 was again among top contributors to returns. The largest bottom contributor to quarterly returns was Ahern Rentals (AHEREN) 7.375% notes due 2023, which traded down with other equipment rentals companies but was more heavily penalized post Q3 results that

saw mixed management commentary on the operating environment. Last quarter’s bottom contributor, Bonanza Creek Energy, Inc. (BCEI) was among the largest bottom contributors again in Q4 but has been liquidated.

Broad High Yield Market Strategy: Performance

	SKY Harbor BHYM Strategy Performance (%)			
	Gross of Fees	ICE BofAML US HY Index	Alpha	Net of Fees
Q1 2018	-0.77	-0.91	0.14	-0.85
Q2 2018	0.80	1.00	-0.19	0.73
Q3 2018	2.26	2.44	0.18	2.18
October 2018	-1.56	-1.64	0.07	-1.59
November 2018	-0.86	-0.91	0.05	-0.89
December 2018	-1.97	-2.19	0.23	-1.99
Q4 2018	-4.33	-4.67	0.33	-4.40
Full Year 2018	-2.15	-2.26	0.12	-2.44
Three Years (annl)	6.74	7.27	-0.53	6.41
Five Years (annl)	3.61	3.82	-0.21	3.29
SI Return (annl)	6.69	6.61	0.08	6.36

Performance includes reinvestment of dividends and other earnings. Gross performance does not reflect the deduction of management fees. Fees disclosed in SKY Harbor’s Form ADV, Part 2A or applicable offering documents. Past performance is not indicative of future results.
SI=Since Inception. Broad High Yield Market Composite inception date: 9/30/11.

SKY Harbor's Unconstrained **Short Duration High Yield Strategy** (SDHY) portfolios posted a negative return in Q4 but outperformed the broader high yield market (as measured by the ICE BofAML US High Yield Index) which was sharply negative for the quarter. While the short duration part of the market was not immune to the selloff, its more defensive nature dampened the volatility experienced by the broader high yield market. By risk type, generally shorter duration, higher quality securities outperformed longer duration and more speculative securities, which were the most penalized during the selloff.

On a representative basis, at quarter-end our SDHY portfolios had a YTW of 7.08% (89% of the broad market yield). Exclusive of cash, the average coupon was 6.51% vs. the market average of 6.36% and the duration-to-worst was 2.5 (or 59% of the broad market). Holdings (299 issues, representing 214 issuers) comprised 42% bonds with maturities of less than three years and 58% 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		
	Gross of Fees	High Yield Market ¹	Market Capture	Net of Fees	SKY SDHY Strategy	High Yield Market ¹	Relative Volatility
Q1 2018	0.43	-0.91	NM	0.34	1.9	3.2	59%
Q2 2018	0.93	1.00	94%	0.85	1.0	2.1	47%
Q3 2018	1.86	2.44	76%	1.78	0.6	1.3	48%
October 2018	-0.64	-1.64	39%	-0.67	1.7	3.2	48%
November 2018	-0.30	-0.91	33%	-0.32	2.0	3.7	54%
December 2018	-1.36	-2.19	62%	-1.39	3.4	5.9	57%
Q4 2018	-2.28	-4.67	49%	-2.36	2.4	4.3	56%
Full Year 2018	0.90	-2.26	NM	0.56	1.7	3.0	55%
Three Years (annl)	4.53	7.27	62%	4.17	1.9	3.7	51%
Five Years (annl)	2.64	3.82	69%	2.29	2.0	3.7	54%
Since Inception (annl)	4.04	5.83	69%	3.66	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 used solely as a relative market indicator. Short Duration High Yield Composite Inception date: 10/31/11. NM = Not meaningful. Performance includes reinvestment of dividends and other earnings. Gross performance does not reflect the deduction of management fees. Fees disclosed in SKY Harbor's Form ADV, Part 2A or applicable offering documents. Past performance is not indicative of future results.

Outlook

We recognize that the risk of decelerating global growth has increased, however, we continue to believe that markets are over-discounting the risk that the US business cycle turns negative. We remain positive on corporate fundamentals and believe defaults will remain near cyclical lows. Importantly, valuations are significantly more supportive of high yield risk taking given the December selloff and the market has repriced to a point where the carry provides a compelling relative return even if spreads do not tighten. Strong technicals associated with lower issuance on the bond side and a potential move from loans back to bonds should also continue to provide support for the market. Taken in whole, we have not substantially altered our risk positioning, although we are mindful of the market's reflection of a peaking profit cycle and the associated shift higher in risk premiums.

Our Broad High Yield Market portfolios remain underweight the better quality, more rate-sensitive segment of the market. We continue to use volatility 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. The market repricing has also given us the opportunity to add income through credit picking among companies with improving earnings. 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 our Short Duration High Yield strategy, we continue to believe our SDHY portfolios are well positioned for the current market environment as they are capturing nearly 90% of the market yield with just over half of the market duration. The typically defensive nature of the portfolio allows us to take advantage of any potential volatility or curve repricing associated with episodic volatility. 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.

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	5.4	5.8	Basic Industry	13.1%	11.4%	115%	
Yield to Worst	7.77%	7.93%	Services	11.4%	5.3%	217%	
Current Yield	7.24%	6.89%	Healthcare	11.4%	10.8%	106%	
Duration to Worst	3.9	4.3	Capital Goods	10.2%	5.5%	186%	
OAS	515	533	Technology & Electronics	10.0%	5.0%	198%	
Avg Coupon	6.92%	6.36%	Media	9.6%	11.3%	85%	
Number of Issuers	200	875	Energy	7.2%	15.4%	47%	
Number of Issues	239	1838	Telecommunications	6.9%	9.4%	74%	
Average ML Rating	B2	B1	Leisure	4.6%	4.7%	99%	
Average Price	95.5	92.3	Retail	3.0%	4.3%	69%	
			Consumer Goods	2.8%	3.0%	96%	
			Automotive	2.5%	1.7%	145%	
			Financial Services	2.0%	4.6%	44%	
			Transportation	1.8%	0.8%	225%	
			Real Estate	1.5%	1.1%	142%	
			Banking	0.9%	2.4%	37%	
			Insurance	0.7%	1.1%	65%	
			Utility	0.2%	2.3%	10%	
Distribution by ML Rating	Portfolio ¹	HY Market					
A Holdings	0.0%	0.0%					
BBB Holdings	0.5%	0.0%					
BB Holdings	27.2%	47.7%					
B Holdings	55.8%	40.7%					
CCC or Under	16.5%	11.6%					
Distribution by Issue Size	Portfolio ¹	HY Market					
0 - 250M	8.2%	1.4%					
250 - 500M	33.2%	28.9%					
500 - 750M	20.8%	20.7%					
750 - 1000M	10.9%	15.8%					
1000+M	26.9%	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
CPG Merger Sub LLC 8.000% 01-Oct-2021	CCC2	315.0	97.50	Basic Industry	2.36	9.25	1.45
Unisys Corporation 10.750% 15-Apr-2022	B1	440.0	109.00	Technology & Electronics	2.00	6.22	1.35
QUAD/GRAPHICS 7.000% 01-May-2022	B2	243.5	96.00	Media	2.87	8.38	1.33
Ahern Rentals Inc. 7.375% 15-May-2023	B3	550.0	79.50	Services	3.46	13.58	1.31
Universal Hospital Services 7.625% 15-Aug-2020	B3	645.0	99.50	Healthcare	1.46	8.12	1.29

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	5.8	3.3	Basic Industry	14.0%	11.4%	12.0%
Yield to Worst	7.08%	7.93%	6.98%	Media	12.3%	11.3%	11.4%
Current Yield	6.63%	6.89%	6.36%	Energy	12.2%	15.4%	15.6%
Duration to Worst	2.5	4.3	2.7	Healthcare	8.8%	10.8%	10.0%
OAS	452	533	443	Telecommunications	7.6%	9.4%	7.9%
Avg Coupon	6.51%	6.36%	6.15%	Capital Goods	7.3%	5.5%	6.7%
Number of Issuers	214	875	407	Services	6.9%	5.3%	5.2%
Number of Issues	299	1838	645	Financial Services	6.3%	4.6%	7.5%
Average ML Rating	B1	B1	BB3	Leisure	5.9%	4.7%	3.8%
Average Price	98.24	92.28	96.66	Technology & Electronics	5.9%	5.0%	4.6%
				Transportation	3.0%	0.8%	1.6%
				Automotive	2.2%	1.7%	1.9%
				Consumer Goods	1.9%	3.0%	2.3%
				Real Estate	1.9%	1.1%	1.1%
				Retail	1.6%	4.3%	3.5%
				Utility	1.0%	2.3%	2.0%
				Banking	0.8%	2.4%	2.1%
				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	1.2%	0.0%	0.0%				
BB Holdings	37.4%	47.7%	50.6%				
B Holdings	51.9%	40.7%	49.4%				
CCC or Under	9.5%	11.6%	0.0%				
Distribution by Issue Size	Portfolio ¹	HY Market ²	SD Universe ³				
0 - 250M	6.6%	1.4%	0.1%				
250 - 500M	33.0%	28.8%	22.7%				
500 - 750M	22.5%	20.6%	27.4%				
750 - 1000M	13.1%	15.7%	11.6%				
1000+M	24.8%	33.5%	38.2%				
Top 5 Holdings by Weight	ICE BofAML Rating	Issue Size (\$mil)	Current Price	ICE BofAML Industry	Duration to Worst	Yield to Worst (%)	% of Portfolio
Sprint Corporation 7.250% 15-Sep-2021	B2	2,250.0	102.37	Telecommunications	2.38	6.29	0.99
DISH DBS Corporation 5.125% 01-May-2020	B1	1,099.6	99.13	Media	1.26	6.11	0.77
DISH DBS Corporation 6.750% 01-Jun-2021	B1	2,000.0	98.75	Media	2.18	7.22	0.77
Reynolds Group Issuer LLC 5.750% 15-Oct-2020	B1	3,236.8	99.75	Capital Goods	1.66	5.89	0.74
HCA Healthcare Inc 6.250% 15-Feb-2021	BB3	1,000.0	102.25	Healthcare	1.93	5.11	0.74

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 December 31, 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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