

High Yield Market Update

Risks around trade policies and their impact on global growth notched lower during the fourth quarter while at the same time the Federal Reserve delivered its third rate cut for the year and the passage of a US spending bill prevented a replay of last year's US government shutdown. Investors in risk assets were focused on the US and China "phase-one" trade deal agreement and the US Senate approval of the US-Mexico-Canada trade pact, and chose generally to not view the drama around US impeachment proceedings as having a material and sustained impact on market risks. For the quarter, WTI Crude was up \$6.99 (or 12.93%) to \$61.06/bbl. The US Dollar Index declined 3.01% and Treasuries ended the quarter with the 2-year down 10 basis points (bps) to 1.58% and the 10-year higher by 23 bps to 1.91% as the yield curve steepened.

Technical were generally more negative due to positive net supply in the period. High yield funds and ETFs had inflows of \$3.9bn while loan funds saw continued outflows of \$8.2bn, as tracked by Lipper and reported by Barclays. Q4 bond new issuance was steady, pricing \$67.9bn in the quarter, offset by \$51.7bn of bond redemptions, leaving net supply at \$16.2bn for the period, per Barclays. The percentage of the market trading at

distressed levels (below 70% of par) ended the quarter at 4.6%; the comparable figure for the loan market (below 80% of par) was 4.4%, per JP Morgan. The par-weighted twelve-month high yield bond default rate increased to 2.04% by quarter-end, per BofA Merrill Lynch. Excluding commodities, the default rate was 0.59%.

The ICE BofA US High Yield Index returned 2.61% in Q4, ending the period with an average price of 100.66, a 1.57-point increase from the prior quarter. Credit spreads tightened by 39 bps to 359 bps and the yield-to-worst (YTW) was lower by 0.44% to 5.37%. High yield underperformed small cap equities, represented by the Russell 2000's 9.93% return, as well as large cap equities, as represented by the S&P 500's 9.06% return, but outperformed investment grade corporates, as represented by the ICE BofA US Corporate Index's 1.15% quarterly return. In high yield, the Double-B, Single-B and Triple-C sub-indices returned 2.37%, 2.83% and 2.80%, respectively. Returns were positive across all sectors for the quarter: the top performer was Automotive, which saw a 5.19% return, while Telecom was the bottom-performing sector, posting a 1.46% return.

Portfolio Performance

Portfolios managed according to our Unconstrained **Broad High Yield Market Strategy** (BHYM) posted strong absolute returns in Q4, modestly underperforming the benchmark due to the late in the year market surge. By risk type, security selection was a source of outperformance while allocation was a source of underperformance. The primary drivers of relative returns were weaker selection within the short duration part of the market as well as an underweight to the higher-performing, most speculative part of the market. Underperformance was largely offset by strong selection within the most speculative part of the market and within the better-quality part of the market (yielding 6-7%). Cash was also a drag during a strong up market. By sector, weaker selection in Retail and Healthcare were sources of underperformance, offset by strong selection in Consumer Goods and Automotive.

On a representative basis, the top contributor to BHYM returns was Tenneco Inc. (TEN) 5% notes due 2026, which traded up during the quarter on solid Q3 results and an unsolicited bid for part of the business. Last quarter's top contributor, Weight Watchers International (WW) 8.625% notes of 2025, was among the top contributors again, trading up on strong Q3 earnings. The largest bottom contributor to quarterly returns was Party City (PRTY) 6% notes due 2026, which traded down sharply during the quarter on

weak earnings. We liquidated this position during the period due to concern that the company has generally extended out its operational turnaround to the point where near-term maturities may become problematic. Last quarter's bottom contributor, TMS International (TMS) 7.25% notes due 2025 traded up during the quarter on Q3 results that were in line with expectations and an overall slight recovery in the steel markets.

Broad High Yield Market Strategy: Performance

	SKY Harbor BHYM Strategy Performance (%)			
	Gross of Fees	ICE BofA US HY Index	Alpha ¹	Net of Fees
October 2019	0.42	0.23	0.19	0.40
November 2019	0.21	0.27	-0.06	0.18
December 2019	1.65	2.09	-0.44	1.63
Q4 2019	2.30	2.61	-0.31	2.22
Full Year 2019	13.88	14.41	-0.53	13.52
Three Years (annl)	6.33	6.32	0.01	6.01
Five Years (annl)	6.05	6.13	-0.08	5.72
SI Return (annl)	7.53	7.52	0.01	7.20

¹ Based on gross of fees. Fees disclosed in SKY Harbor's Form ADV, Part 2A. SI=Since Inception. Broad High Yield Market Composite inception date: 9/30/11. Past performance is not indicative of future results.

SKY Harbor's Unconstrained **Short Duration High Yield Strategy** (SDHY) portfolios posted solid absolute returns during the fourth quarter, capturing over half of the broader US high yield market return (as measured by the ICE BofA US High Yield Index), on a gross basis, with significantly less volatility. Generally, longer duration (within the context of short duration) outperformed shorter duration securities and more speculative securities in the fourth quarter. By sector, Insurance and Basic Industry were the top performers for the period, while Retail and Energy lagged, posting the only negative returns. By rating, Single-Bs outperformed Triple-Cs and Double-Bs although the dispersion among the rating sub-groups was minimal.

On a representative basis, at quarter-end our SDHY portfolios had a YTW of 3.51% (65% of the broad market yield). Exclusive of cash, the average coupon was 6.15% vs. the market average of 6.34% and the duration-to-worst was 1.2 (or 41% of the broad market). Holdings (321 issues, representing 218 issuers) comprised 38% bonds with maturities of less than three years and 62% 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. Acknowledging that we are in the late stage of economic recovery, we have been gradually increasing overall credit quality.

Short Duration High Yield Strategy: Performance

	SKY Harbor SDHY Strategy Performance (%)				Annualized Daily Volatility		
	Gross of Fees	High Yield Market ¹	Market Capture ²	Net of Fees	SKY SDHY Strategy	High Yield Market ¹	Relative Volatility
October 2019	0.32	0.23	139%	0.30	0.6	2.2	29%
November 2019	0.39	0.27	143%	0.36	0.7	1.6	44%
December 2019	0.61	2.09	29%	0.58	0.6	1.7	34%
Q4 2019	1.33	2.61	51%	1.25	0.6	2.0	33%
Full Year 2019	9.05	14.41	63%	8.70	1.4	2.8	49%
Three Years (annl)	4.92	6.32	78%	4.56	1.4	2.7	52%
Five Years (annl)	4.44	6.13	72%	4.08	1.9	3.6	51%
Since Inception (annl)	4.64	6.84	68%	4.26	1.8	3.4	54%

¹ The Short Duration High Yield strategy is not a benchmarked strategy. The HY Market index shown (ICE BofA US HY Index) is used solely as a relative market indicator.

² Based on gross of fees. Fees disclosed in SKY Harbor ADV, Part 2.

Short Duration High Yield Composite Inception date: 10/31/11.

Past performance is not indicative of future results.

Outlook

While geo- and US political risks and China are likely to continue to impact risk premiums, overall high yield fundamentals and technicals remain generally supportive, in our view. We acknowledge an aging economic cycle and the increasing gap between the performance of the manufacturing sector that is the bedrock of the “old” economy and the service and asset light sectors that dominate the “new” economy. We view 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 are modestly underweight the better-quality, lower-yielding 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 focus on those industry groups that are best positioned for sustainable growth in an aging economic cycle. We remain underweight the Energy sector and

industries that have a high degree of sensitivity to Chinese growth, and are generally biased towards US consumer driven industries and companies with a high degree of US revenue. Our BHYM portfolios remain more concentrated in high conviction holdings. Based on our view of risks and valuations across the market, we continue to believe lower-rated credit and short duration risk 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 two-thirds of the market yield with about 40% 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, tenders and maturities, will continue to allow us 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	5.5	5.8	Basic Industry	15.1%	10.6%	142%	
Yield to Worst	4.81%	5.37%	Services	11.9%	5.9%	202%	
Current Yield	6.52%	6.30%	Healthcare	11.4%	9.8%	117%	
Duration to Worst	2.2	2.9	Media	11.0%	10.6%	103%	
OAS	300	359	Technology & Electronics	8.4%	5.2%	163%	
Avg Coupon	6.80%	6.34%	Capital Goods	8.3%	6.5%	128%	
Number of Issuers	145	838	Leisure	4.9%	5.3%	92%	
Number of Issues	165	1788	Consumer Goods	4.7%	3.6%	131%	
Average ML Rating	B2	B1	Financial Services	3.9%	4.4%	87%	
Average Price	104.2	100.7	Telecommunications	3.6%	10.4%	35%	
			Real Estate	3.4%	1.7%	194%	
			Insurance	3.2%	1.1%	295%	
			Retail	2.9%	4.7%	62%	
			Transportation	2.4%	1.0%	231%	
			Automotive	2.0%	2.0%	99%	
			Banking	1.9%	2.1%	94%	
			Energy	0.9%	12.5%	8%	
			Utility	0.0%	2.5%	0%	
Distribution by Rating	Portfolio ¹	HY Market					
A Holdings	0.0%	0.0%					
BBB Holdings	0.0%	0.0%					
BB Holdings	25.8%	49.1%					
B Holdings	51.5%	38.8%					
CCC or Under	22.8%	12.0%					
Distribution by Issue Size	Portfolio ¹	HY Market					
0 - 250M	7.2%	1.2%					
250 - 500M	45.1%	28.4%					
500 - 750M	13.5%	21.3%					
750 - 1000M	11.6%	15.6%					
1000+M	22.6%	33.6%					
Top 5 Holdings by Weight	BofA Rating	Issue Size (\$mil)	Current Price	BofA Industry	Duration to Worst	Yield to Worst (%)	% of Portfolio
Townsquare Media Inc. 6.500% 01-Apr-2023	B3	280.1	101.50	Media	1.17	5.24	2.43
Bausch Health Americas, Inc. 9.25% 01-Apr-2026	B2	1,500.0	115.00	Healthcare	2.02	4.23	2.12
Unisys Corporation 10.750% 15-Apr-2022	B1	440.0	107.50	Technology & Electronics	0.28	3.09	2.01
Great Lakes Dredge & Dock Corp. 8% 15-May-2022	B3	325.0	105.75	Transportation	0.37	3.09	1.98
QUAD/GRAPHICS 7.000% 01-May-2022	B3	243.5	94.00	Media	2.07	9.91	1.95

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	3.6	5.8	3.2	Media	12.7%	10.6%	10.0%
Yield to Worst	3.51%	5.37%	4.30%	Financial Services	11.0%	4.4%	6.3%
Current Yield	5.92%	6.30%	5.95%	Basic Industry	9.9%	10.6%	12.6%
Duration to Worst	1.2	2.9	1.7	Telecommunications	9.5%	10.4%	8.7%
OAS	184	359	267	Capital Goods	8.8%	6.5%	6.1%
Avg Coupon	6.15%	6.34%	6.07%	Healthcare	8.6%	9.8%	8.9%
Number of Issuers	218	838	431	Leisure	7.9%	5.3%	4.4%
Number of Issues	321	1788	665	Services	6.5%	5.9%	5.0%
Average Rating	B1	B1	BB3	Technology & Electronics	5.1%	5.2%	5.0%
Average Price	103.76	100.66	102.11	Transportation	3.8%	1.0%	2.6%
				Retail	3.7%	4.7%	3.7%
				Consumer Goods	3.3%	3.6%	3.0%
				Real Estate	2.9%	1.7%	2.3%
				Energy	2.3%	12.5%	14.6%
				Automotive	1.8%	2.0%	1.6%
				Utility	0.7%	2.5%	2.2%
				Banking	0.6%	2.1%	2.0%
				Insurance	0.5%	1.1%	1.1%
				Other	0.4%	0.0%	0.0%
Distribution by Rating	Portfolio ¹	HY Market ²	SD Universe ³				
A Holdings	0.0%	0.0%	0.0%				
BBB Holdings	3.3%	0.0%	0.0%				
BB Holdings	43.7%	49.1%	54.8%				
B Holdings	45.4%	38.8%	45.2%				
CCC or Under	7.6%	12.0%	0.0%				
Distribution by Issue Size	Portfolio ¹	HY Market ²	SD Universe ³				
0 - 250M	3.9%	1.2%	0.0%				
250 - 500M	30.9%	28.3%	24.2%				
500 - 750M	18.1%	21.2%	26.3%				
750 - 1000M	15.1%	15.5%	13.7%				
1000+M	32.1%	33.8%	35.8%				
Top 5 Holdings by Weight	Average Rating	Issue Size (\$mil)	Current Price	BofA Industry	Duration to Worst	Yield to Worst (%)	% of Portfolio
Reynolds Group Issuer LLC. 5.750% 15-Oct-2020	B1	3,136.8	100.00	Capital Goods	0.08	4.19	0.87
Sprint Corporation 7.250% 15-Sep-2021	B2	2,250.0	105.75	Telecommunications	1.58	3.73	0.77
Nationstar Mortgage LLC 6.500% 01-Jul-2021	B2	491.6	100.25	Financial Services	0.08	3.49	0.75
Tenet Healthcare Corporation 8.125% 01-Apr-2022	B3	2,799.4	110.63	Healthcare	2.04	3.19	0.75
International Game Technology 6.25% 15-Feb-2022	BB2	1,500.0	105.50	Leisure	1.51	2.76	0.73

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, 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 BofA US High Yield Index "HOAO" (HY Market) and ICE BofA 1-5 Year BB-B US Cash Pay High Yield Constrained Index "JCV4" (SD Universe).

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