

*Applying a deep value approach to the credit markets with an emphasis on downside business risks and creditor protections is key to investing in high yield bonds. Anthony Ranaldi, portfolio manager of the DDJ High Yield Bond Strategy, applies rigorous business and legal diligence on middle market companies in his pursuit of undiscovered gems in this segment of the market.*

## Hidden Middle Market Yields

### Q: What is the history and investment objective of the firm?

**A:** DDJ Capital Management, LLC is a Waltham, Massachusetts-based high yield and distressed investment manager which was launched in 1996.

DDJ Capital Management currently manages \$3.8 billion in assets primarily for pensions, endowments, foundations and unions. The High Yield Strategy comprises \$2.9 billion of total assets and focuses on non-investment grade corporate bonds and bank loans issued by U.S. companies, with a bias toward middle market companies.

Our founder, David J. Breazzano, serves as the firm's President and Chief Investment Officer, and I am the portfolio manager for the High Yield Bond Strategy. DDJ has 44 employees with 18 members on the investment team, including three in-house attorneys. The firm prides itself on its team approach.

The investment objective of the firm is to produce consistently superior long-term investment returns while minimizing downside risk.

### Q: What are the tenets of your investment philosophy?

**A:** We employ a bottom-up, fundamental approach emphasizing rigorous due diligence and downside protection. We seek to manage downside risk by buying into companies at a significant discount to intrinsic value and by selecting securities with strong creditor protections.

We focus on middle market companies that are often overlooked by market participants and provide a great source of investment opportunities. We find much better access to management with middle market companies, which allows us to conduct deeper research and develop relationships with management teams.

We also focus on lower credit quality securities due to their technical inefficiencies and rating inaccuracies. From both a research and sourcing perspective, our high yield strategy benefits greatly from DDJ's distressed/special situation experience both from a research and a sourcing perspective.

### Q: How is investing in high-yield bonds different from investing in investment grade bonds?

**A:** High-yield bonds are rated below investment grade (Ba/BB- or lower). The lower credit rating implies an increased element of risk relative to investment grade bonds (Baa/BBB or higher) and investors are compensated for this increased risk with greater yield. There are many differences between investing in high yield bonds and investment grade bonds but a few of the more significant differences are the size of the companies, credit statistics such as the leverage ratio, free cash flow characteristics, default risk and interest rate sensitivity. The main difference, as I see it, is the margin of error is lower with high yield issuers making the fundamental research process and legal diligence much more important. Ironically, however, because investors in investment grade bonds believe that they have a higher margin of error, these securities often lack fundamental creditor protections as compared to securities issued in the high yield market.

### Q: How would you describe your investment strategy?

**A:** The firm pursues two investment strategies on behalf of its clients; high yield and distressed/special situations.

The investment team and research process are the same for both of these strategies. The main difference between the two strategies is that high yield seeks to buy performing bonds or bank loans while distressed/special situations seeks to invest in a diversified portfolio consisting of control and non-control distressed debt, high yield bonds and bank loans, and special situations that provide high current income and the potential for capital appreciation.

We focus on what we believe are the most inefficient segments of the credit market and apply a value-based approach to identify mispriced securities. We have relatively low turnover and try to build a portfolio of only 60-80 issuers. Our approach enables us to create a comprehensive analytical overview of companies by focusing on their current and future business prospects. By closely following the changes in a target company's credit condition, we often capture superior information and identify new investment opportunities.

Another important aspect of our strategy is our legal diligence. Our three in-house attorneys help uncover elusive strengths and weaknesses in loan documents and bond indentures. Our high yield strategy benefits from our distressed expertise because we are able to identify structural/legal risk that become most important in downside scenarios.

### DDJ High Yield Bond Strategy

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Portfolio Manager

**Anthony Ranaldi** joined DDJ in 2002 and has more than 13 years of experience investing in the high yield, distressed and equity markets. As portfolio manager, Ranaldi is responsible for all day-to-day portfolio management responsibilities for DDJ's High Yield Strategy.

Prior to joining DDJ, from 2000 to 2002 he was an associate at Spectrum Equity Investors, a private equity firm specializing in telecom and media and from 1997-2000 he was a research analyst in the High Yield Group at Morgan Stanley Dean Witter. Ranaldi received his BA from Princeton University.

“We seek to generate excess returns while managing downside risk and delivering lower volatility versus a broad-based high yield benchmark over full credit cycles. We focus on lower credit quality, stressed and distressed middle market companies.”

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### **Q: What is your research process?**

**A:** Our analysts are specialists covering two to four sectors each and are responsible for being experts in the industries they follow. The analysts regularly conduct and present to the investment team industry reviews to form or challenge an existing macro investment thesis on a particular sector. From these reviews, the goal is to identify the most attractive companies and relative value securities within a particular sector.

We have a two-phase research process. The first phase is what we call the “first pass” where the analyst pulls together a financial model, conducts a competitive analysis, typically speaks with management and identifies the pros and cons of a target opportunity. This process can take one to two weeks at which point I will sit down with the analyst and we will decide if it makes sense to conduct the second phase, which we call the “deep dive”.

The “deep dive” can take anywhere from a few weeks to a few months where the analyst works through a diligence checklist. Areas for evaluation include the company’s senior management, industry fundamentals, market share and competitive positioning, pricing power, operations, and historical projected financial performance.

The investment team considers information from a wide range of reliable resources, including company filings, interviews with company management, customers, competitors, suppliers, loan officers, consultants, crisis managers, attorneys, investment bankers and other creditors. Additionally, DDJ has a network of external industry professionals called the DDJ Management Advisory Group to help us on a more granular level.

The investment team conducts weekly meetings to discuss any revisions or new affecting investments in the portfolio. During this weekly meeting an analyst will also present either an industry review or a new opportunity being considered.

### **Q: What is your sell discipline?**

**A:** There are a few reasons to sell. One is, if a bond trades up to a level that no longer offers a compelling risk/reward proposition and does not meet the hurdles for the accounts that we manage, we will swap out of that position into a more attractive position.

Second is, if something has fundamentally changed in our investment thesis and we feel as though the market has not appropriately reacted to it or reflected it in the trading prices, we will sell out of that security aggressively.

The third reason we would sell a security is for compliance reasons. If a position approaches a specified limit due to capital appreciation or other relative value swings we will generally sell down the position in order to maintain compliance with investment guidelines and portfolio diversification objectives.

### **Q: How do you execute your portfolio construction?**

**A:** We typically hold between 60 and 80 securities at any given time in the portfolio. Our top ten names typically represent anywhere between 25% and 40% of the portfolio and our top 25 names generally account for two-thirds of the portfolio. We overweight high confidence positions.

We typically start with a 1% position size and scale into positions over time. The maximum position size is 5%. We invest in no more than 25% in any given industry. Sector weightings are driven by a bottom-up approach, independent of the benchmark.

As long-term holders, we have a holding period ranging between 12 months to five years in certain situations. Our targeted turnover is in the 40% range.

### **Q: What are the sources of risk and how do you contain it?**

**A:** The risks that we encounter are many but we try to mitigate them at various levels. Some of the risks associated with investing are credit risk, liquidity risk, structural/legal risk and interest rate risk.

We believe that the best way to manage credit risk and structural/credit risk is to do your work thoroughly and continually be on top of your positions. Our investment approach of having 5-10 investments per analyst allows for thorough analysis and monitoring.

DDJ will take liquidity risk but limit the exposure to less liquid positions to 15% of the strategy. In addition, these less liquid positions typically command a significant premium to our liquid positions.

In the current environment, DDJ has managed interest rate risk by actively shortening duration. Our average duration is approximately 3 years right now. We believe that rates will go higher in the coming years and if you are long duration, you are exposed in our opinion.

Another component of controlling risk is to stick to your core beliefs and to not style drift. DDJ invests in businesses where there is significant transparency in their underlying cash flow and we have a high level of conviction in what the business is worth. Just because financial companies, for example, have become such a large percentage of the index doesn’t mean we need to chase them if they don’t fit with our approach. Financial companies are far from transparent, operate under extreme leverage and many of the names in our market required government intervention to survive, which was a coin flip from an investors standpoint.

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