DDJ CAPITAL MANAGEMENT, LLC
SPECIALISTS IN HIGH YIELD AND LEVERAGED CREDIT INVESTMENTS

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CIO’s Perspective

2016 Leveraged Credit Review and 2017 Outlook

> 2016 was a year to remember; leveraged credit markets showed resilience in the face of unexpected electoral results at home and abroad.

> Although the credit cycle is in the latter stages, it seems reasonable to expect a coupon-like return environment in 2017.

David J. Breazzano
President, Chief Investment Officer, Portfolio Manager

Mr. Breazzano is a co-founder of DDJ and has more than 36 years of experience in high yield, distressed, and special situations investing. At DDJ, he oversees all aspects of the firm and chairs the Management Operating, Remuneration, and Investment Review Committees. Mr. Breazzano also serves as the portfolio manager of DDJ’s U.S. Opportunistic High Yield and Total Return Credit Strategies.

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2016 Review

High yield bond performance in 2016 (as measured by the BofA Merrill Lynch U.S. High Yield Bond Index ("HYBI")) recovered from early losses to post the asset class's third highest annual total return during the past twenty years (17.49%), trailing only 2009 (57.51%) and 2003 (28.15%), respectively. As Exhibit 1 below shows, after generating an impressive gain of 9.32% through the first six months of the year, high yield bonds added an additional 7.47% in 2H16. High yield bond spreads compressed considerably in 2016, tightening a total of 273 basis points, including a 199 basis points decline in the second half of the year ("2H16").

Similarly, leveraged loans (as measured by the JP Morgan Leveraged Loan Index ("LLI")) generated solid results, posting a gain of 9.78% for the year. This increase was the fourth largest in the index's ten year history. In addition, leveraged loan performance of 5.24% in 2H16 was more attractive than the first half of the year. Spread compression for leveraged loans in the second half of the year was a healthy 113 basis points, far exceeding the 46 basis points of tightening experienced by leveraged loans during 1H16.

Exhibit 1: Performance and Characteristics of High Yield Bonds and Leveraged Loans[1]

	Dec 31, 2015	1H 2016	Dec 31, 2016	∆ 2H 2016
High Yield Bonds (HYBI)				
Total Return YTD	-4.64%	9.32%	17.49%	7.47%
Yield (YTW)	8.76%	7.36%	6.17%	-1.19%
Spread (OAS)	695 bps	621 bps	422 bps	-199 bps
Price	88.82	95.27	99.60	4.33
Coupon	6.66%	6.60%	6.51%	-0.09%
Current Yield	7.50%	6.93%	6.54%	-0.39%
Average Rating	B1	B1	B1	Unch
Effective Duration	4.38	4.41	4.25	-0.16
Default Rate (Par(100))	3.08%	4.68%	3.98%	-0.70%
Leveraged Loans (LLI)				
Total Return YTD	0.54%	4.31%	9.78%	5.24%
Yield (3-Year)	7.55%	6.52%	6.23%	-0.29%
Spread (3-Year)	617 bps	571 bps	458 bps	-113 bps
Price	93.39	95.56	98.22	2.66
Default Rate (Par)	2.02%	2.18%	1.49%	-0.69%

Source: BofA Merrill Lynch and JP Morgan.
The BofA Merrill Lynch U.S. High Yield Bond Index ("HYBI") and the JP Morgan Leveraged Loan Index ("LLI")
Past performance is no guarantee of future results

1. Default statistics for 2015 and 2016 include distressed exchanges.

Energy and Basic Industry sector performance topped all other sectors in 2016

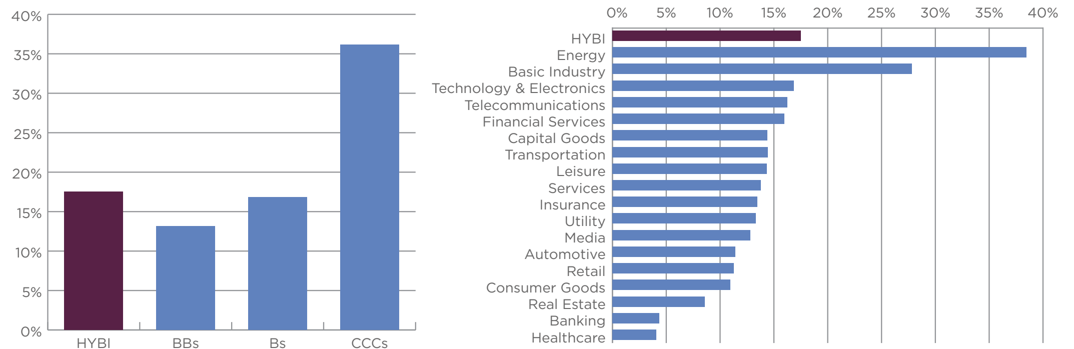
Rating and Sector Performance

Breaking down performance into ratings and sector categories reveals the winners and losers for the full year. Similar to what we reported at the mid-year point, triple Cs (36.14%) outperformed both double B rated (13.14%) and single B rated (16.85%) high yield bonds. However, the gains for double Bs in 2H16, although impressive, were not as fruitful as those experienced in 1H16. The majority of this second half lag can be attributed to the change in sentiment around interest rates. As economic conditions in the U.S. showed continuing signs of improvement, it became increasingly likely that the U.S. Federal Reserve (the "Fed") would resume its hiking cycle. As market participants digested this story-line during 2H16, 2yr, 5yr and 10yr U.S. Treasury yields experienced an increase of 60 bps, 91 bps and 96 bps, respectively, with more than half of that increase occurring after the U.S. presidential election. As a result, double B rated bonds, which tend to have higher durations, given their lower coupons and longer maturities, and thus are more sensitive to increasing rates, felt the pinch of higher rates and lagged considerably in 2H16 relative to single B and triple C names.

From a sector perspective, Energy and Basic Industry sector performance topped all other sectors in 2016, and were two of the strongest performers during the second half of the year. The increase in oil prices, which began in mid-February, along with improved sentiment with regards to future oil prices resulted in significant price appreciation among Energy sector issues, ultimately lifting the entire high yield market during the first half of the year. In addition, continued appreciation in the price of oil, as well as other commodities, helped sustain the rally in these sectors through the remainder of 2016. Furthermore, the Financial Services sector experienced a surge in performance during the back half of the year. Higher rates provided a tailwind to financials, making this group the second best performing sector in the second half of the year trailing only the Energy sector. While higher rates bode well for the Financial Services sector, they can damage the profitability of Utility companies; as such, the Utilities sector experienced a sell-off in the second half that resulted in it being one of the weakest performers during that period.

However, the biggest loser in 2016 was the Healthcare sector, which just barely produced a positive return in the second half of the year. Whether it was rhetoric from both presidential candidates about Affordable Care Act ("ACA") reform/repeal, concerns surrounding drug pricing practices, or issuer specific credit concerns (e.g., Valeant Pharmaceuticals), the Healthcare sector was under pressure from the very beginning of the year. Therefore, it is not surprising that Pharmaceuticals, a component of the Healthcare sector, was the only sub-sector in the HYBI to produce a negative return (-4.00%) during 2016.

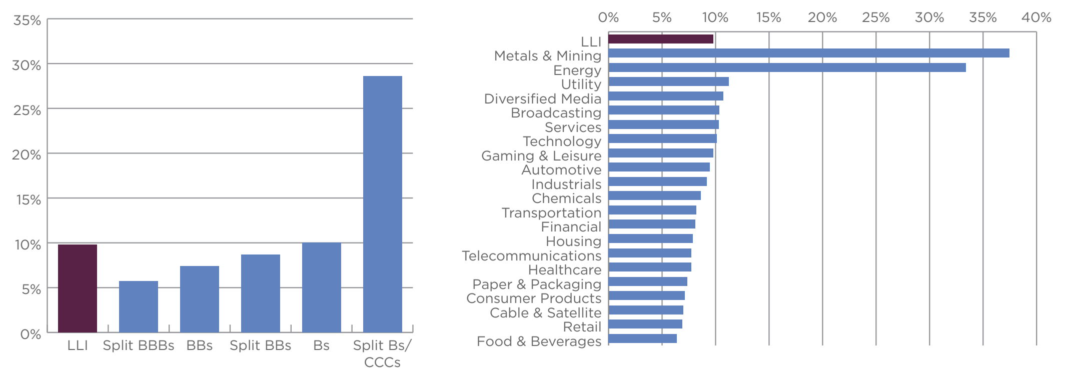
Exhibit 2: HYBI Rating and Sector Performance: 1/1/2016 – 12/31/2016



Source: BofA Merrill Lynch; The BofA Merrill Lynch U.S. High Yield Bond Index ("HYBI")
Past performance is no guarantee of future results

The story for leveraged loan performance during 2016 was slightly different from that of high yield bonds, as 2H16 was the stronger half with respect to leveraged loan performance. However, as Exhibit 3 demonstrates, it was a similar story insofar as the lowest rated leveraged loans significantly outperformed higher rated loans, while those loans in the Energy and Metals & Mining sectors also considerably outperformed all other sectors. Leveraged loan prices, which were supported throughout the year by CLO origination, received additional support in 2H16 from the rise in U.S. Treasury yields that we noted earlier. In addition, the expectation of higher rates in the future and the potential protection against such rises afforded by the floating-rate nature of leveraged loans, led to a reversal of flow activity for leveraged loan mutual funds. More specifically, the $5.5 billion in outflows that occurred during 1H16 were erased, and the asset class ended the year with a net inflow of $5.3 billion. This inflow followed two years of outflows in 2014 and 2015, and marked the first inflow for leveraged loan mutual funds since 2013 when $63 billion flowed in.

Exhibit 3: LLI Rating and Sector Performance: 1/1/2016 – 12/31/2016



Source: JP Morgan; The JP Morgan Leveraged Loan Index ("LLI")
Past performance is no guarantee of future results

As we turn the page on 2016, we begin to examine the factors that can influence our market in the coming year and beyond. A new presidential administration in the United States, together with a potential shift in both monetary and fiscal policy, will most likely continue to add to the volatility recently experienced in our market.

…from 2010 through 2016, primary market activity in the Healthcare sector ranked second, trailing only the Energy sector.

2017 Outlook

As credit selectors, we believe that 2017 will prove to be a year in which fundamentals rise to the forefront after more recently taking a back seat to the support provided by accommodative monetary policy and, more recently, a rapid increase in commodity prices (aka "positive technicals"). Given the rise in U.S. Treasury yields following the election and the subsequent decline in the amount of negative yielding debt during the second half of 2016, the high yield market has more competition for yield hungry investors. In addition, in the United States, the trend, for now, appears to be an increase in the likelihood of further Federal Funds Rate increases in light of the fiscal policy initiatives discussed by the incoming administration. Furthermore, since OPEC reached a deal in November to cut production, oil prices have somewhat stabilized above $50. As a result, high yield market performance may be less influenced by commodity price movements, assuming that such deal is honored and economic activity does not stall.

One of the easiest predictions that one could have made prior to the U.S. presidential election was that regardless of which candidate won the presidency, given the current polarization between the two political parties, a large group of people in the United States would be unhappy with the result. However, as we move beyond inauguration day, we may be able to begin to incorporate the potential effects a Trump presidency may have on the markets. If President Trump runs his administration similar to how he campaigned, the next four years may be somewhat unconventional to say the least, and it certainly remains to be seen if it will have a disruptive or positive effect on the domestic and global economy. However, given the administration's focus on tax reform and deregulation, a case can be made that such policies could provide a friendlier environment for businesses, which in turn may result in an increase in economic activity and improved financial results for such businesses. Conversely, President Trump has also shown a tendency to use rhetoric with respect to protectionist policies, which could have the opposite effect on economic activity.

Sector Spotlight: Healthcare

Regardless of which candidate won the election, the Healthcare sector seemed destined to receive some attention from the new President. While Secretary Clinton seemed more focused on the Pharmaceutical industry and examining drug pricing practices, as well as some ACA reform, President Trump has made it clear that repealing "Obamacare" is one of his top priorities. As is often the case during the campaign cycle, candidates can be short on details when it comes to policy, so we await the specifics of exactly how the existing law will be altered or in fact replaced now that President Trump has assumed office.

The Healthcare sector of the high yield market has enjoyed impressive growth since President Obama came into office and the ACA took effect. During the period from 2010 through 2016, primary market activity in the Healthcare sector ranked second, trailing only the Energy sector. During this time, the Healthcare sector has seen its share of the HYBI increase by 30.5%, from 7.2% in December 2009 to 9.4% as of December 2016. In addition, over the same period, while the HYBI saw its market value increase from $802.7 billion to more than $1.3 trillion, or 63.6%, the Healthcare sector saw its market value in the HYBI increase 113.6%.

...high yield bonds historically have absorbed rate increases through spread compression.

Regardless of how changes to the ACA are implemented, it seems inevitable that there will be volatility in the Healthcare sector moving forward, and while changes often take time to effectively implement, the new administration seems focused on moving as quickly as possible. Although the aging population in the U.S., as well as in several large developed/ developing economies outside of the U.S., remains a tailwind for the sector, a disruption to existing law has the potential to flush out weaker issuers and possibly serve as a drag on market performance during the year. However, as is often the case in volatile or disruptive times, opportunities to invest in solid credits within the Healthcare sector will undoubtedly materialize.

Interest Rates in Focus

In December, the U.S. Federal Reserve raised interest rates again for only the second time since it began its latest hiking cycle at the end of 2015. At that time, market pundits called for as many as three such hikes during 2016. We find ourselves in a familiar situation to start 2017, as similar predictions have surfaced and another year of multiple hikes once again has been forecasted.

In general, high yield bonds historically have absorbed rate increases through spread compression. In other words, rates typically rise in connection with improved economic conditions, which usually results in improved financial performance for high yield issuers, leading to better credit profiles and tighter spreads. However, given the compression in spreads that occurred in 2016, one has to ask whether or not there is much room for further tightening. As Exhibit 4 reveals, relative to the end of 2015, spreads at the end of 2016 are considerably tighter, whether one looks at the market as a whole or by ratings category. In addition, if one compares year-end 2016 spread levels to the "low" achieved in June 2014, there appears to be even less room for tightening, especially among double B rated issues.[2] As such, significant rate increases have the potential to negatively affect the performance of the high yield market in the coming year.

Exhibit 4: Historic Option Adjusted Spread ("OAS")

	HYBI	HYBI – BBs	HYBI – Bs	HYBI - CCCs
December 31, 2015	695	424	715	1,653
December 31, 2016	422	271	410	971
Low for Credit Spreads: June 2014	337	236	330	627
Difference between Dec' 15 OAS and "Low" OAS	358	188	385	1,026
Difference between Dec' 16 OAS and "Low" OAS	85	35	80	344

Source: BofA Merrill Lynch
Past performance is no guarantee of future results

The probability of further rate increases in 2017 seems higher than in years past. However, our focus will not be on the number of such hikes or the level at which interest rates ultimately reside, but rather a continued focus on what effect, if any, such an increase will have on the fundamental health of the issuers in which we invest.

[2] The "low" referenced above reflects the latest "inflection point" and accordingly represents the easiest time for debtors to obtain debt financing during the course of a credit cycle.

Speaking of Fundamentals

We task our analysts with concentrating on the fundamental health of the businesses in which we invest or target for future investment. However, it is nonetheless important to recognize broader themes within our market in an effort to better understand where we are in the credit cycle. Two such data series that we monitor and have discussed previously in this format are the trends in issuer fundamentals, such as leverage and interest coverage, and lending standards (i.e., access to capital) within the high yield market. Broadly speaking, leverage remains near peak levels as corporate earnings remain under pressure, but growth in total debt has slowed. In addition, interest coverage, which has been a bright spot for fundamentals, has started to decline from peak levels further softening the outlook for fundamentals.[3] Conversely, the U.S. Federal Reserve's Senior Loan Officer Opinion Survey on Bank Lending Practices most recent survey (October 2016) disclosed a relaxation of lending standards on commercial and industrial loans during the second half of 2016. Although leverage remains near peak levels, and interest coverage has weakened, fundamentals remain in reasonable shape. This fact coupled with continued access to capital for issuers, at least for the time being, may provide support for the current credit cycle to extend further.

Another item of interest is what effect the breaching of the London Interbank Offered Rate ("LIBOR") floor has on issuer fundamentals and subsequently loan prices. According to JP Morgan, approximately 91% of the market weight of the LLI comprises loans with a LIBOR floor, compared to around 1% ten years ago and 52% just five years ago. Given the decline in LIBOR since the Financial Crisis in 2007-08, this trend makes sense to us. The vast majority of loans in the LLI have a floor of 1%, and as LIBOR recently crossed that threshold, it appears that such loans will begin paying higher coupons in short order.[4] The question then becomes how loan issuers fair financially with the burden of higher interest payments.

The answer of course is that it depends on a number of factors. Is an increase in interest rates (i.e., LIBOR) associated with an increase in economic activity and improved financial results? Does new money continue to flow into the asset class as it did during in the second half of 2016? For example, as LIBOR increases, interest expense rises. If such a rise in interest rates is accompanied by improved economic growth and corporate earnings, the result should be stable or improving issuer fundamentals, supporting tighter spreads. In addition, a continuation of the trend in leveraged loan mutual fund inflows would be supportive of loan prices, as loans in a rising rate environment will become more attractive investments on a relative basis. However, while macro factors may positively influence the overall economy as well as specific sectors, each individual credit must nevertheless be carefully analyzed to fully understand the impact of any rise in interest rates (and, with respect to loans, the corresponding increase in interest expense).

3. Interest coverage, defined as EBITDA divided by total interest expense, is used to assess a company's ability to pay interest expense on outstanding debt. EBIDTA is an acronym for Earnings before interest, tax, depreciation and amortization.

4. Source: JP Morgan

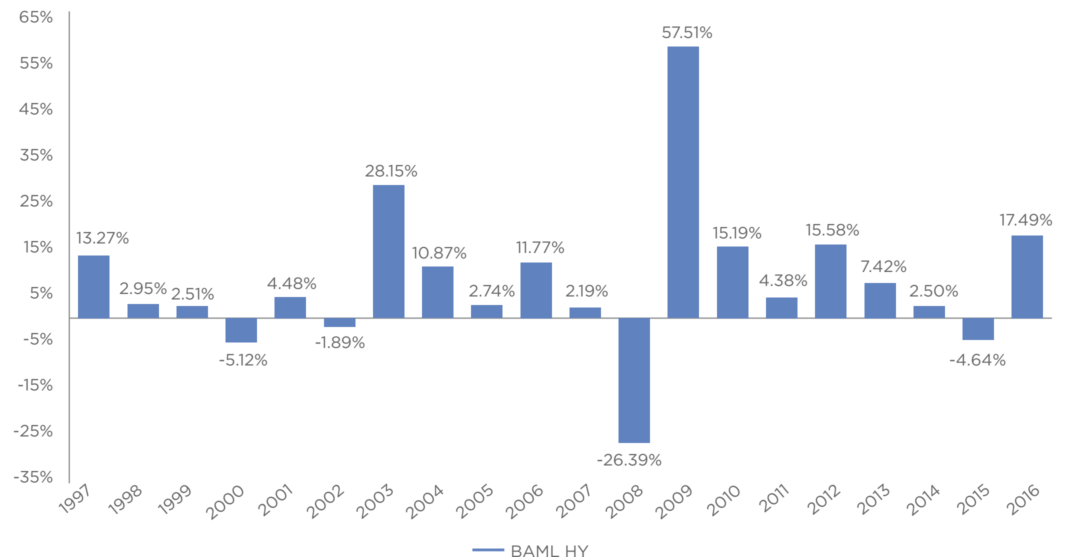
...mid-single digit performance following a rally such as that experienced in 2016 is a reasonable expectation.

Since the Financial Crisis, and during this period of ultra-low interest rates, floating-rate leveraged loans have been a popular way for high yield issuers to access capital markets. This type of borrowing provides issuers with the flexibility to prepay their debt with little to no penalty (where such penalty is in the form of higher call premiums). However, as interest rates rise, borrowers typically will want to fix their interest costs and accordingly may issue fixed rate high yield bonds to replace existing loan structures. Therefore, we could see a contraction in loan issuance, thereby creating some degree of scarcity in loans. As a result, this loan scarcity may cause the spread over LIBOR for remaining loans to compress, thus supporting loan prices.

Summary

As we are constantly reminded, past performance is no guarantee of future results. That being said, based on the data provided in Exhibit 5, it seems unlikely that the high yield market will be able to muster another year of double digit gains in 2017. Although it is not impossible, such performance in back-to-back years is uncommon and historically only happens following a recession. History would tell us that mid-single digit performance following a rally such as that experienced in 2016 is a reasonable expectation. Given the current status of issuer fundamentals that we described earlier, coupled with the diminished ability for spreads to tighten and absorb rate increases, a coupon-like return for the high yield market seems to be a realistic best case scenario to us. Furthermore, while a rapid increase in rates seems unlikely given its potential impact on economic activity together with the Fed's stated intention to take a measured approach to rate increases, significant rate increases would quickly derail this estimate.

Exhibit 5: Calendar Year Performance HYBI: 1/1/1997 – 12/31/2016



Source: BofA Merrill Lynch
Past performance is no guarantee of future results

For those of us investing in the high yield market, 2016 will certainly be a year to remember. After a rough start caused by numerous factors, including concerns around economic growth and a sharp decline in oil prices, accommodative monetary policy and a recovery in commodity prices helped the leveraged credit market achieve one of its best years on record. In addition, the new administration's stance on fiscal policy has been interpreted by markets as being "pro-growth" and inflationary, which helped further fuel an increase in high yield and leveraged loan prices during the latter stages of the year.

Although we believe that it is late in the credit cycle, the resilience that this market has shown in the face of shocks like the "Brexit" vote and the largely unexpected result in the U.S. presidential election makes us wonder what will eventually disrupt the current credit cycle and result in a broader increase in default rates. Whatever that event is, it is out of our control. However, we try to control what we can, such as the quality of our research and a strict adherence to our bottom-up fundamental process. The application of such process we believe should identify positions most prone to a default and accompanying downside, as well as those investments offering attractive yields for the risks being incurred.

Every year presents investors with new challenges, and unfortunately no one provides a blueprint for what they will be or a manual on how to navigate them. However, as investors, we must use our collective knowledge base to direct our clients' portfolios through whatever lies ahead. My experience tells me that credit selection is the key to long-term success in the high yield market. Identifying attractive yielding investments in what our research concludes are fundamentally sound businesses provides the opportunity for us to achieve long-term success for our clients.

Organizational Update

Six Months Ending	**December 31, 2016**
Total Assets Under Management (MM)	$7,589
Total Number of Accounts	41
Personnel Updates: Material Changes (Positions)	None
Material Departures	None
Material Additions	Douglas Wooden (Senior Research Analyst) Matthew Hensher (Director, Business Development and Client Service)

Appendix

BPS: Stands for basis points. A basis point is one one-hundredth of one percent (0.0001).

Brexit: Brexit is an abbreviation for "British exit," which refers to the June 23, 2016, referendum whereby British citizens voted to exit the European Union.

Collateralized Loan Obligation ("CLO"): A CLO is a form of securitization where payments from multiple middle sized and large business loans are pooled together and passed on to different classes of owners in various tranches.

Coupon: The stated interest rate paid on a bond. Coupon payments for high yield bonds are typically made semi-annually.

Effective Duration: A duration calculation for bonds with embedded options. Effective duration takes into account that expected cash flows will fluctuate as interest rates change.

High Yield Bond: A high yield bond is a debt security issued by a corporate entity where the debt has lower than investment grade ratings. It is a major component – along with leveraged loans – of the leveraged credit market.

Investment Grade: investment grade are those securities rated Baa3/BBB-/BBB- or above by Moody's, S&P, and/or Fitch, respectively.

LBO: A leveraged buyout (LBO) is the acquisition of another company using a significant amount of borrowed money to meet the cost of acquisition.

Monetary Policy: Monetary policy is the actions of a central bank, currency board or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates. Monetary policy is maintained through actions such as modifying the interest rate, buying or selling government bonds, and changing the amount of money banks are required to keep in the vault (bank reserves).

Option Adjusted Spread: A measurement of the spread of a fixed-income security rate and the risk-free rate of return, which is adjusted to take into account an embedded option. Typically, an analyst would use the Treasury securities yield for the risk-free rate. The spread is added to the fixed-income security price to make the risk-free bond price the same as the bond.

Spread: The yield of a bond minus the yield of the government bond that matches the maturity (or appropriate call date) of the bond.

Spread Compression: Spread compression is when spreads go down.

Yield: The yield is the income return on an investment, such as the interest or dividends received from holding a particular security.

Disclosures

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The BofA Merrill Lynch US High Yield Index tracks the performance of US dollar denominated below investment grade corporate debt publicly issued in the US domestic market. Please note that one cannot invest in the index.

The J.P. Morgan Leveraged Loan Index is designed to mirror the investable universe of USD institutional leveraged loans, including US and international borrowers. Please note that one cannot invest in the index.

Moody's Investors Service and Standard and Poor's Financial Services use a different nomenclature for their ratings system. For example, the Moody's equivalent to a S&P rating of CCC+ is Caa1. For information on the rating agencies' methodology go to: https://www.moodys.com or www.standardandpoors.com.

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ABOUT DDJ CAPITAL MANAGEMENT

DDJ Capital Management's goal is to consistently produce attractive long-term investment returns, while minimizing downside risk for our investors, which include:

> Corporate pension accounts and public retirement plans

> Endowments and foundations

> Insurance companies

> Other institutional clients

The underpinning of DDJ — a disciplined investment philosophy, coupled with a commitment to exhaustive credit research — has remained constant since our founding in 1996. Our highly skilled team is steadfast and focused on executing our strategy to identify strong risk-adjusted investment opportunities in the leveraged credit markets.

For information on DDJ's investment capabilities, please contact:

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Jack O'Connor, head of business development and client service at DDJ, is a representative of ALPS Distributors, Inc.