
Risks and Rewards in High Yield Bonds

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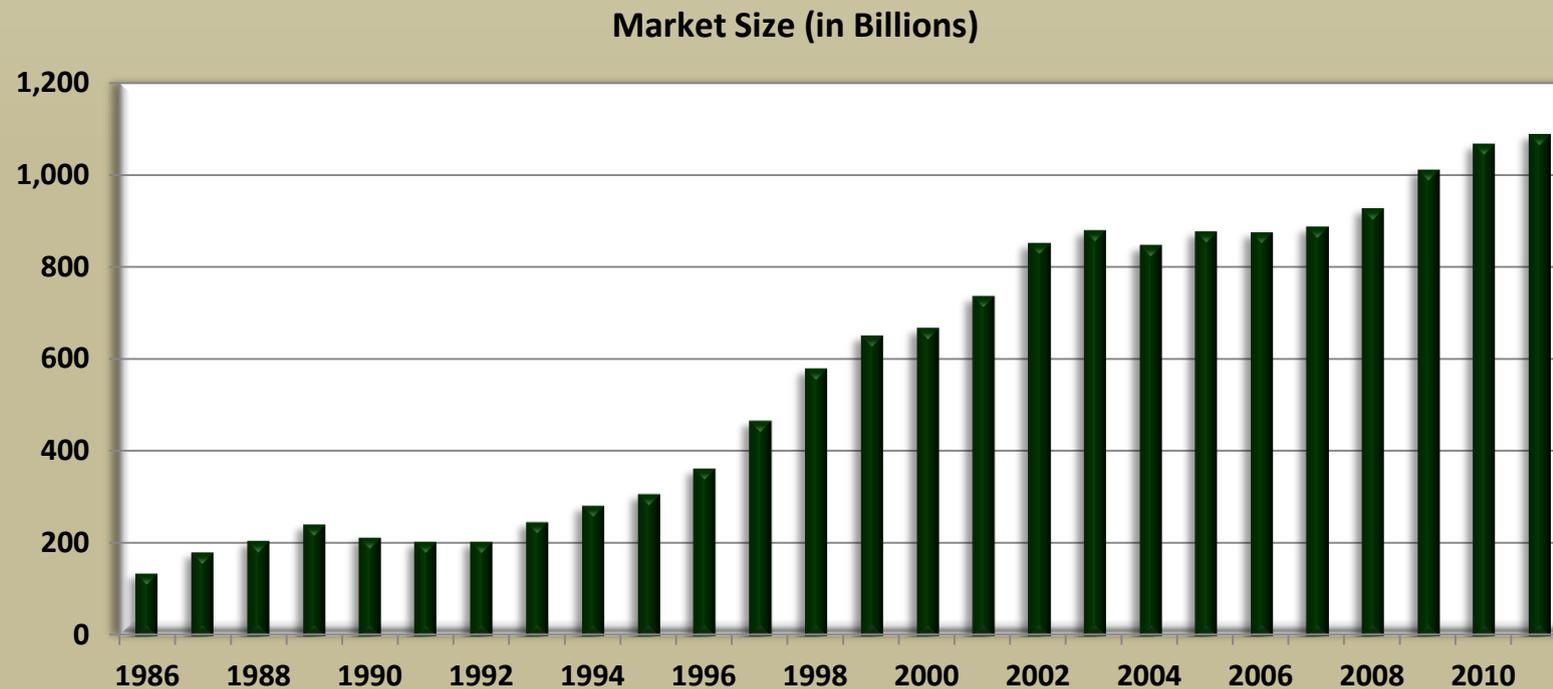
What is a High Yield Bond?

- Bonds rated below the top 4 rating tiers by rating agencies (S&P, Moody's, Fitch)
- Also referred to as “non-investment grade”, “speculative grade” or “junk bonds”
- Familiar High Yield Issuers*
 - ♦ *Sprint Nextel*
 - ♦ *Chrysler*
 - ♦ *Liberty Mutual*
 - ♦ *Sears*
 - ♦ *Rite Aid*
 - ♦ *Sirius XM Radio*
 - ♦ *Goodyear*
 - ♦ *Toys R Us*
 - ♦ *E*Trade*
 - ♦ *Bank of America*
 - ♦ *Hertz*
 - ♦ *Burger King*

* Company names are for illustrative purposes only. Their inclusion is not meant to be an endorsement of any company, bond issue or security.

High Yield Market Overview

- Over \$1 trillion market
- New issuance of \$913 billion since 2009
- Inflows of over \$26.2 billion into the market YTD in 2012



Two Components of High Yield Return: Principal and Coupon

Coupon:

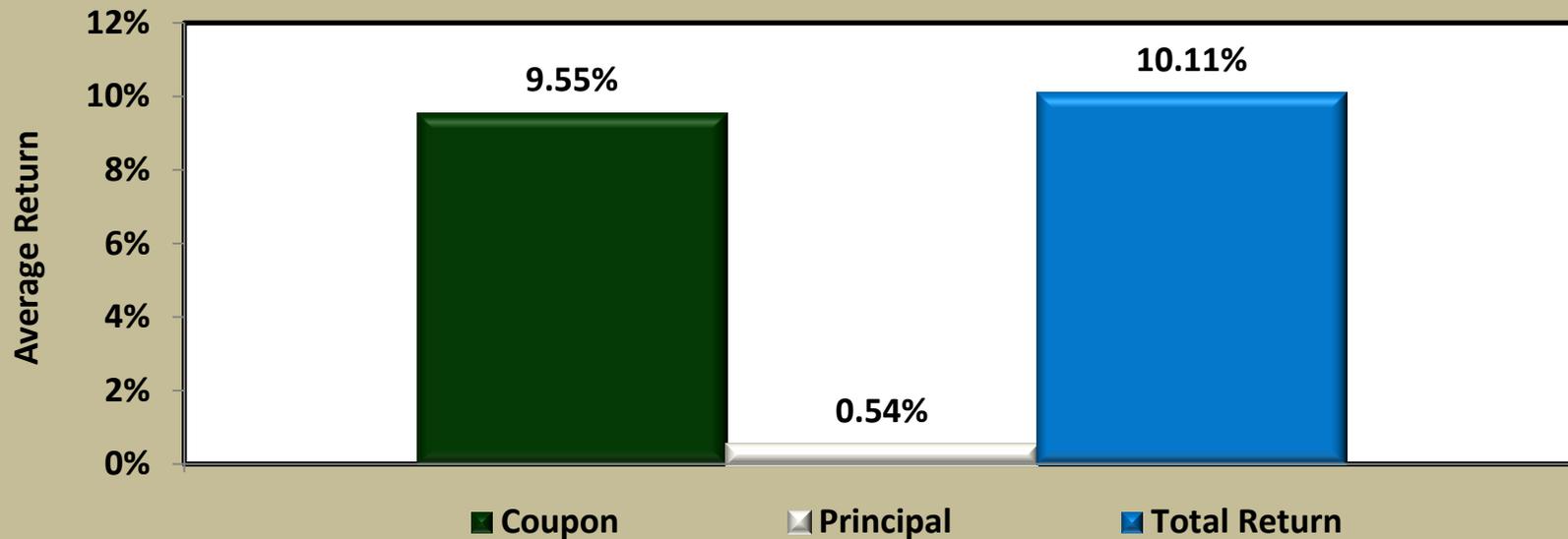
- Drives the return
- Cushions the downside
- Generates cash

Principal:

- Capital gains generated by purchasing bonds at a discount
- Active management is key to avoidance of defaults and principal loss

Total Return meets/exceeds actuarial assumptions!

Credit Suisse High Yield Index Return Breakdown 1986 - 2011



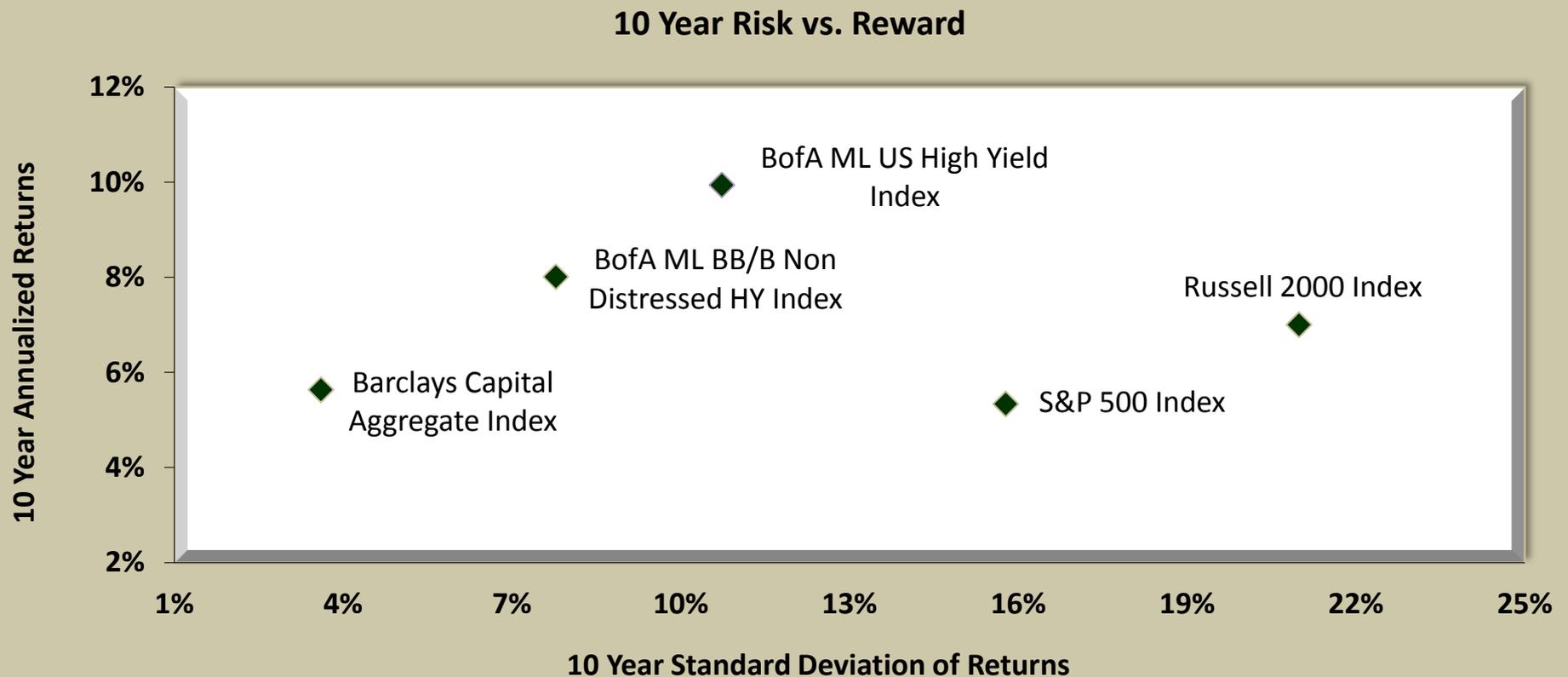
High Yield Correlations Between Various Assets: 1980 - 2011

- Low correlation to other fixed income asset classes
- High yield has a higher correlation to equity, though experiences significantly less volatility

| January 1980 to December 2011 | US 30 Day TBill | US Inter Gov. | US Long Term Gov | ML Mortg | ML Corp. | Barclay Agg. Bond | S&P 500 | Russell 2000 | MSCI EAFE | Gold |
|-------------------------------|-----------------|---------------|------------------|----------|----------|-------------------|---------|--------------|-----------|------|
| High Yield Bonds | -0.02 | 0.25 | 0.22 | 0.42 | 0.61 | 0.45 | 0.55 | 0.57 | 0.50 | 0.08 |

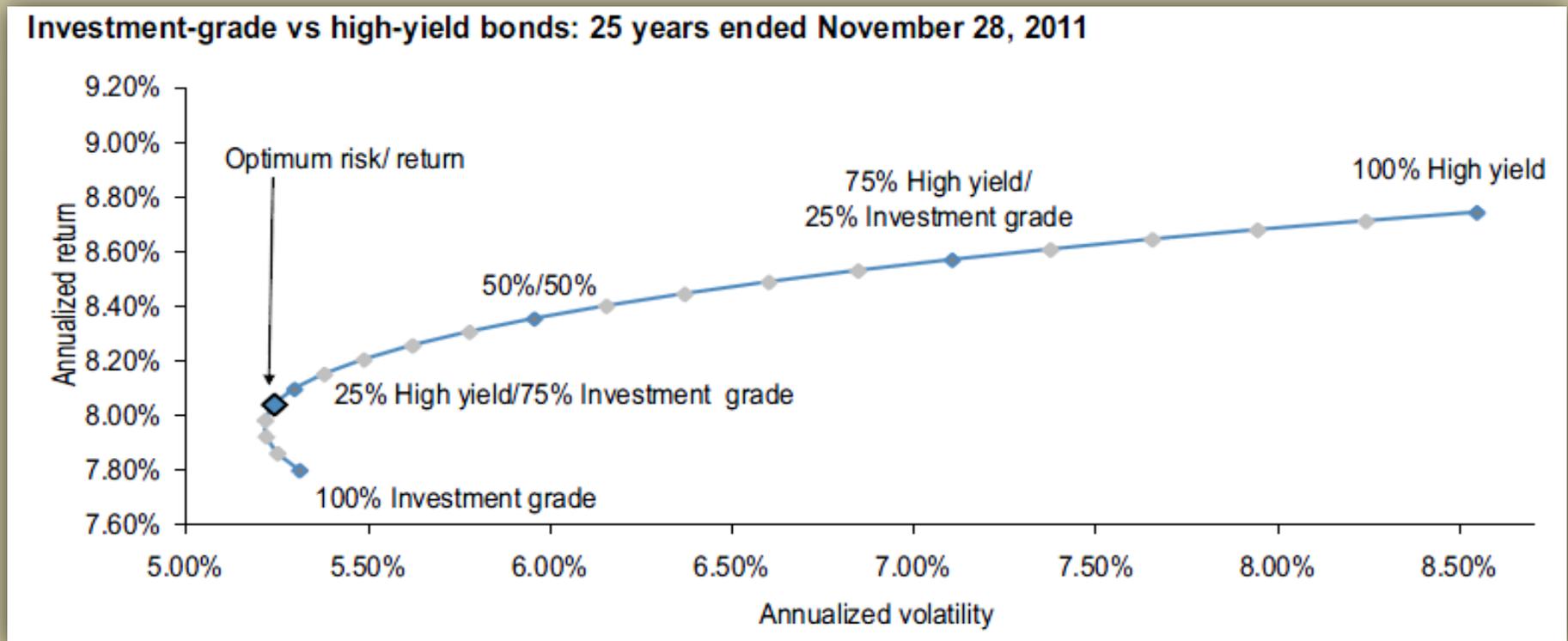
Risk vs. Reward

- Since 1980, High Yield has outperformed the Russell 2000 while slightly underperforming the S&P 500 with half the volatility
- High yield bonds have produced a negative calendar year return only four times since 1980!



The Optimal Portfolio Allocation: Investment Grade and High Yield

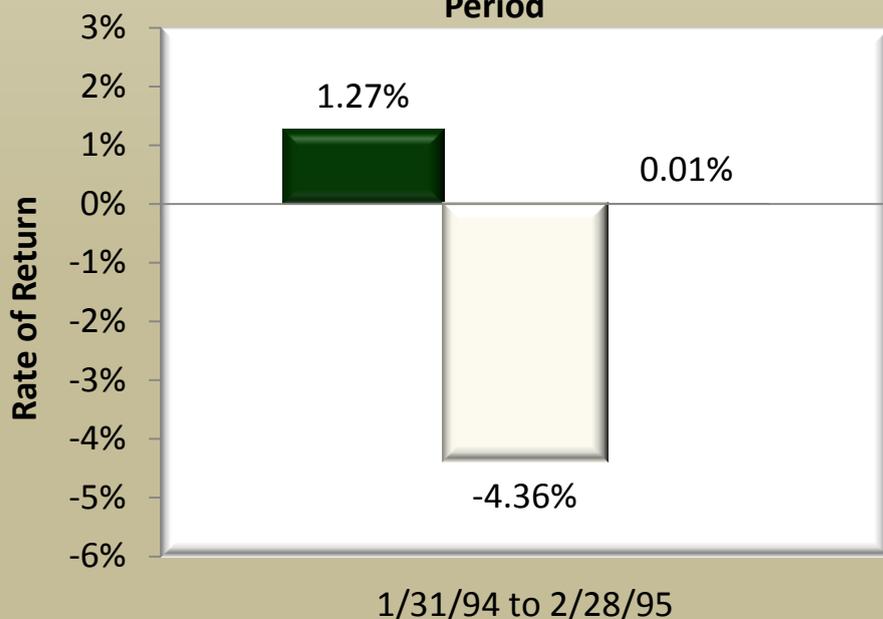
- With low default expectations through 2013, we see a distinct benefit of adding high yield to an investment grade portfolio
- Based on a 25 year analysis, the volatility of a portfolio declines until a mix of 15% high yield and 85% investment grade is reached



High Yield in a Rising Rate Environment

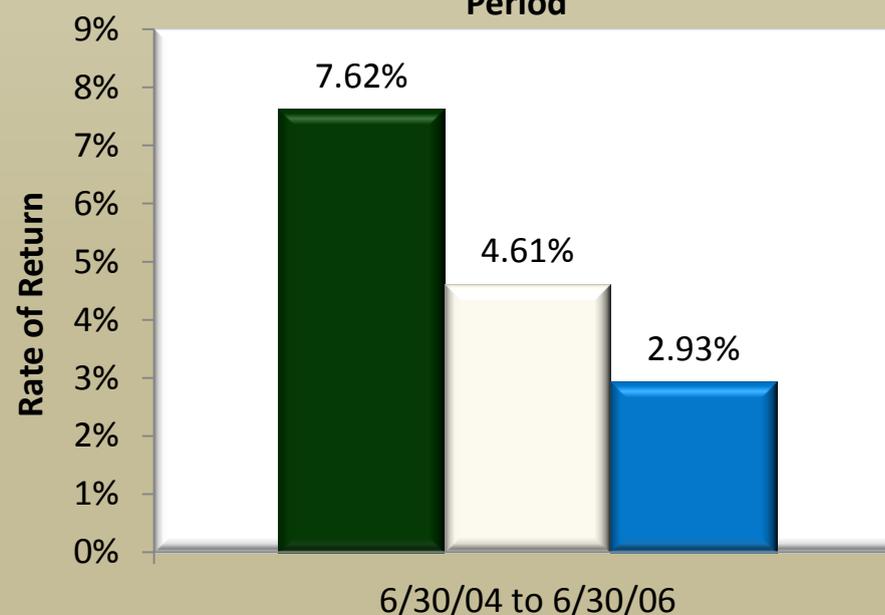
- High yield has historically performed well in rising rate environments
- These two periods were mid-cycle, during an improving economy

Performance Returns During Fed Rate Hike Period



- ML US HY Index
- ML US 10 year Treasury Index
- Barclays Aggregate Index

Performance Returns During Fed Rate Hike Period

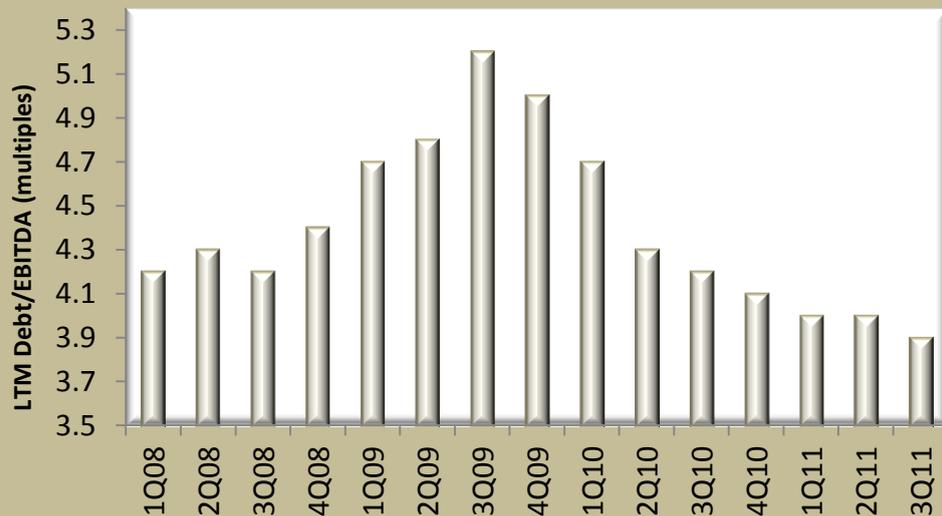


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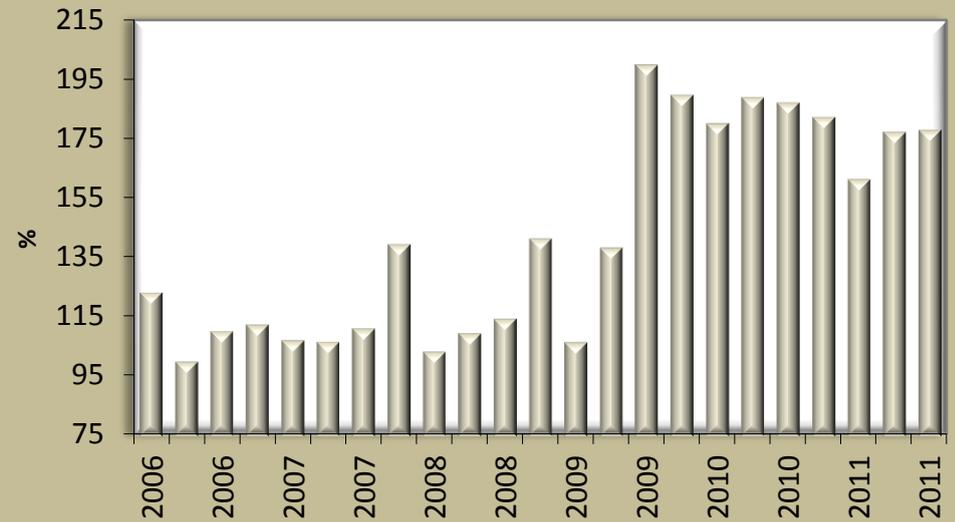
High Yield Fundamentals: U.S. Corporate Fundamentals Remain Solid

- Despite tepid GDP growth, credit metrics for high yield issuers have steadily improved
 - *Leverage/debt outstanding has decreased*
 - *Cash on hand and interest coverage ratios have improved*
 - *Maturities have been pushed out lowering default risk*
- **Upside catalysts remain as corporate deleveraging/refinancing continues and strategic M&A increases**

Leverage Continues to Decline



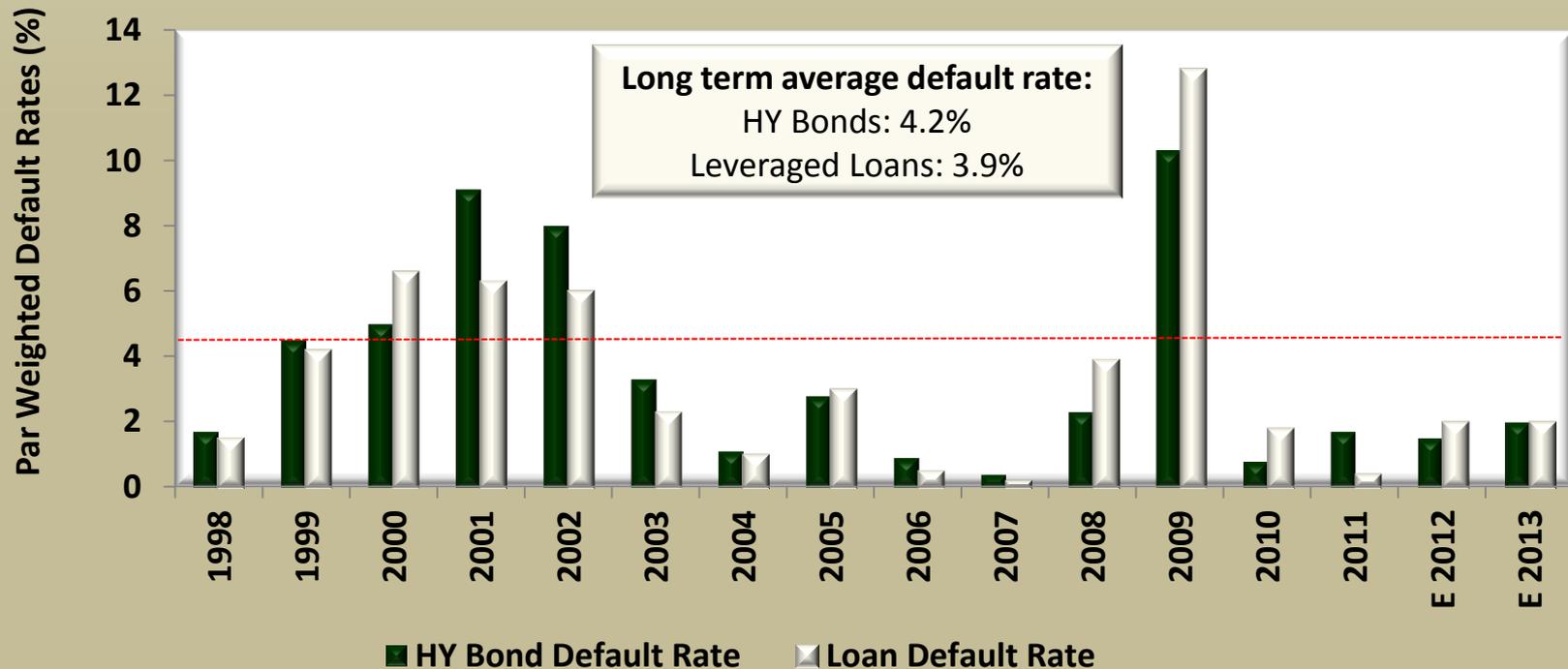
Cash as a Percentage of Short Term Debt



High Yield Fundamentals: Default Rates Expected to Remain Near Record-Low Levels

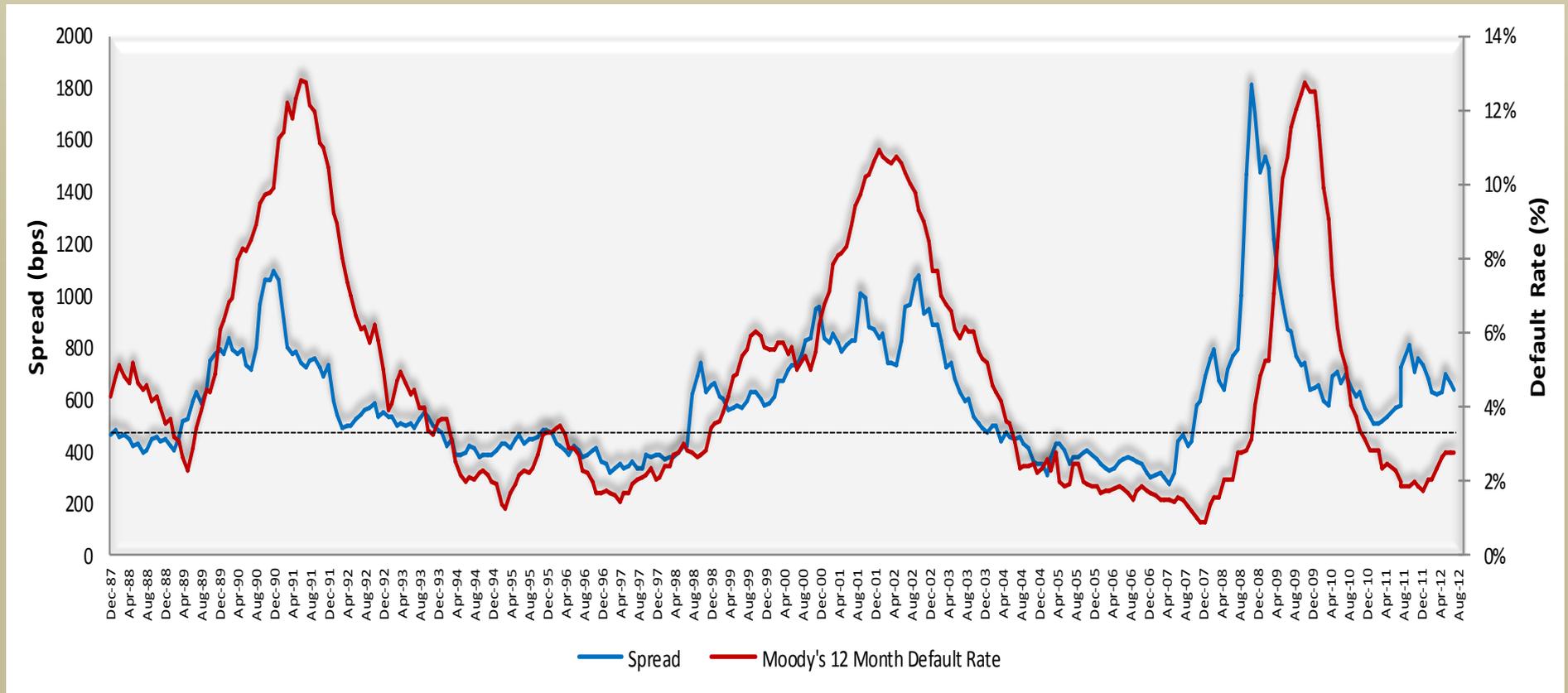
- Default rates are well below historic averages and are expected to remain low due to the lack of lower quality new issuance
- The primary risk of default rates rising stems from several large LBO's with maturities in 2014 that appear unable to refinance

High Yield Bond and Loan Default Rates to Remain Low for the Next Two Years



Current Valuation

- Despite low yields relative to historic levels, the spread pickup versus treasuries adequately compensates investors for default risk

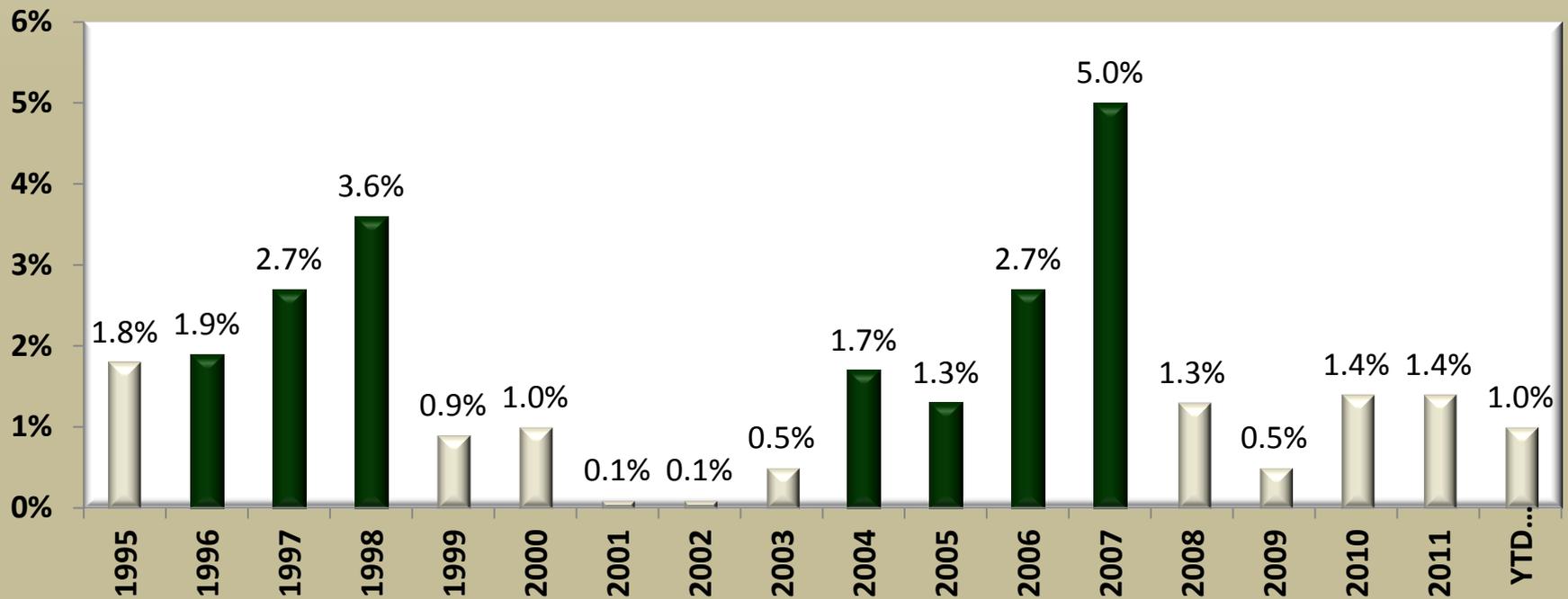


Spread Source: CS First Boston High Yield Index Spread to Worst vs. 10yr. U.S. Treasury Bond
Default Source: Moody's 12 month Trailing Default Rate: Percent of Issuers Basis

High Yield Technicals: New Issuance has been Very Healthy

- Low quality, non-refinance issuance has remained low
- 60% of issuance has been to refinance existing debt
- Speculative issuance for acquisitions and LBOs remains below the key 25% level
- We expect High Yield companies to be net beneficiaries of acquisition activity

Lower Rated New-Issue Volume, Excluding Refinancings*



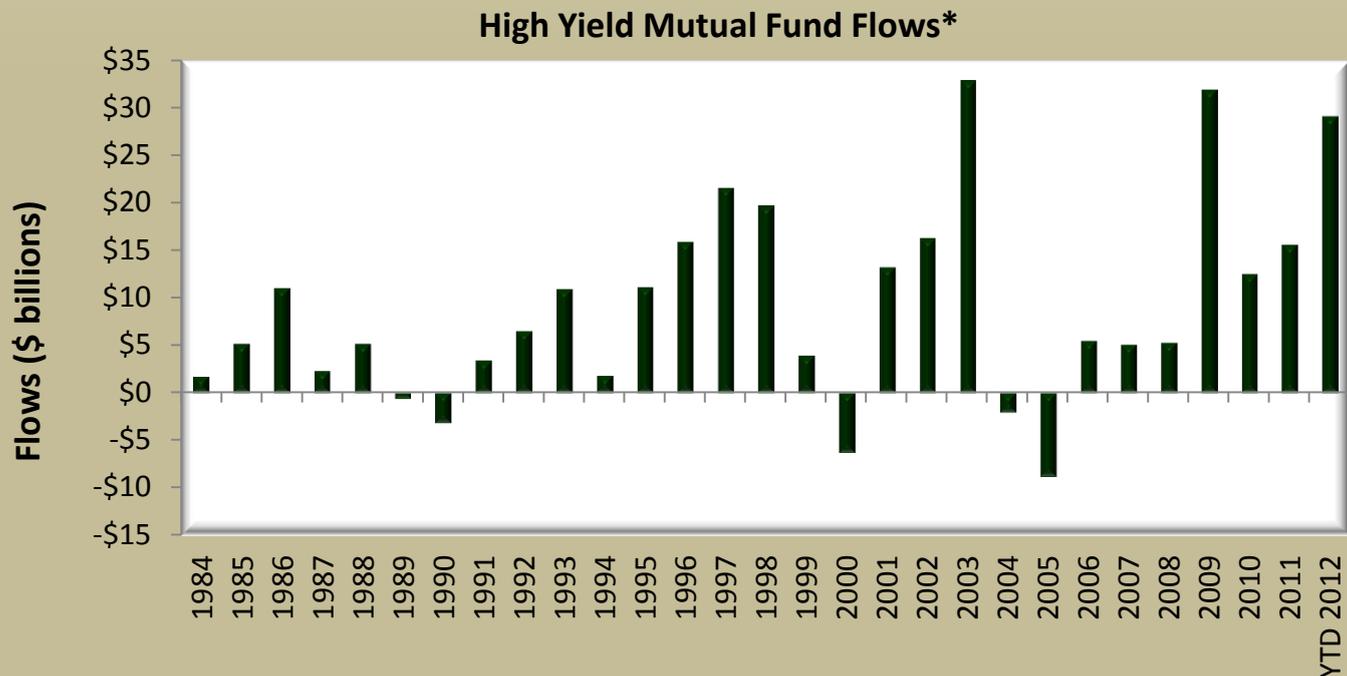
* Source: JP Morgan

Graph as of July 31, 2012

Lower rated new issuance includes bonds rated Split-B or lower

High Yield Technicals: Inflows

- With yields across most other fixed income assets near all-time lows, the current yield to worst of the high yield market of 6.8% is extremely attractive
- Inflows continue to be strong after a robust 2011
 - YTD, inflows into high yield bond funds are \$26.2 billion (compared to \$15.6 billion for 2011)
- The need for yield combined with stable U.S. economic data, strong corporate balance sheets and low default expectations will continue to fuel inflows



* Source: Credit Suisse

Outlook

Economy

- Moderate GDP growth
- Continued low interest rates and inflation remains in check
- Capital expenditure and employment improve, but unemployment remains elevated

High Yield Market

- Negative real interest rates and strong credit fundamentals fuel continued demand
- Default rate remains below long term average
- Upside catalyst from M&A as large, cash-rich companies spur growth through acquisitions
- Security selection will continue to drive returns and avoiding defaults is paramount
- ***Expect coupon type returns over the next 12-18 months***

Risks/Rewards in High Yield Bonds

Risks:

- US recession
- Macro fears fuel a flight to quality
- Decreased liquidity of secondary market

Rewards:

- Generates high levels of cash/income
- Low correlation to other fixed income asset classes
- Increases diversification, lowers volatility and improves risk adjusted returns
- Lower sensitivity to rising interest rates
- Equity like returns with half the volatility
- **Meets/exceeds actuarial assumptions!**

The Case for a Strategic Allocation to High Yield – The Three P's

Protection:

- High yield bonds are senior in the capital structure
- Increases diversification and risk adjusted returns and lowers total portfolio volatility
- High coupon cushions downside during economic downturns
- Short duration nature offers protection from rising rates

Paid to Wait:

- High Yield is currently yielding 6.8% with an average coupon of 8.0%*
- Coupon has historically accounted for 94% of High Yield total returns**

Performance:

- Provides meaningful real returns due to high coupons
- Since 1980, high yield has produced equity-like returns with half the volatility
- Has historically outperformed other fixed income asset classes in rising rate environments
- **Meets/exceeds actuarial assumptions**

* Source: BofA Merrill Lynch

** Source: Credit Suisse

Performance Disclosure

This information should not be considered as a recommendation to purchase or sell a particular security.

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Past performance is not a guarantee of future results and diversification does not ensure against loss.

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CAPITAL MANAGEMENT

Appendix

High Yield Correlations Between Various Assets: 1980 - 2011

| January 1980 to December 2011 | US 30 Day TBill | US Inter. Gov. | US Long Term Gov | ML Mortg | ML Corp. | Barc Agg. Bond | Barc AAA Corp. | S&P 500 | Russell 2000 | DJ Wilsh 5000 | MSCI EAFE | Gold | US Inflat | FTSE NAREIT - All |
|-------------------------------|-----------------|----------------|------------------|-------------|-------------|----------------|----------------|-------------|--------------|---------------|-------------|-------------|-------------|-------------------|
| US Inter. Term Gov. | 0.07 | | | | | | | | | | | | | |
| US Long Term Gov | -0.01 | 0.89 | | | | | | | | | | | | |
| ML Mortgage | 0.06 | 0.06 | 0.85 | 0.79 | | | | | | | | | | |
| ML Corp. | 0.02 | 0.81 | 0.81 | 0.85 | | | | | | | | | | |
| Barclay Agg. Bond | 0.07 | 0.93 | 0.90 | 0.94 | 0.94 | | | | | | | | | |
| Barclay AAA Corp. | 0.03 | 0.88 | 0.89 | 0.88 | 0.94 | 0.96 | | | | | | | | |
| S&P 500 | 0.03 | 0.06 | 0.09 | 0.17 | 0.31 | 0.20 | 0.21 | | | | | | | |
| Russell 2000 | -0.01 | -0.04 | -0.01 | 0.08 | 0.21 | 0.10 | 0.11 | 0.83 | | | | | | |
| DJ Wilshire 5000 | 0.02 | 0.04 | 0.07 | 0.15 | 0.30 | 0.18 | 0.19 | 0.99 | 0.90 | | | | | |
| MSCI EAFE | -0.01 | 0.03 | 0.04 | 0.12 | 0.26 | 0.15 | 0.15 | 0.66 | 0.60 | 0.66 | | | | |
| Gold | -0.18 | 0.07 | 0.03 | 0.04 | 0.08 | 0.05 | 0.03 | 0.03 | 0.09 | 0.06 | 0.17 | | | |
| US Inflation | 0.39 | -0.13 | -0.21 | -0.10 | -0.12 | -0.12 | -0.17 | -0.04 | -0.05 | -0.04 | -0.06 | 0.03 | | |
| FTSE NAREIT - All | -0.04 | 0.08 | 0.08 | 0.15 | 0.32 | 0.20 | 0.20 | 0.58 | 0.67 | 0.61 | 0.48 | 0.10 | -0.02 | |
| High Yield Bonds | -0.02 | 0.25 | 0.22 | 0.42 | 0.61 | 0.45 | 0.43 | 0.55 | 0.57 | 0.58 | 0.50 | 0.08 | 0.00 | 0.59 |

Risk/Reward versus Various Asset Classes

| January 1980 to December 2011 | Annualized Total Return | Annualized Standard Deviation | Highest Annual Return | Lowest Annual Return | Annual Median Return | # of Positive Return Years | # of Negative Return Years | Sharpe Ratio |
|-------------------------------|-------------------------|-------------------------------|-----------------------|----------------------|----------------------|----------------------------|----------------------------|--------------|
| US 30 Day TBill | 4.90 | 0.97 | 13.97 | 0.05 | 4.81 | 32 | 0 | 0.00 |
| US Int. Gov. | 8.73 | 6.44 | 29.10 | -3.59 | 9.33 | 29 | 3 | 0.62 |
| US Long-term Gov. | 10.24 | 12.29 | 40.36 | -13.26 | 9.65 | 26 | 6 | 0.49 |
| ML Mortgage | 8.82 | 7.24 | 40.15 | -1.60 | 7.31 | 31 | 1 | 0.57 |
| ML Corp. | 9.12 | 7.73 | 35.53 | -6.82 | 9.11 | 29 | 3 | 0.58 |
| Barclay Agg. | 8.69 | 6.16 | 32.62 | -2.92 | 7.86 | 30 | 2 | 0.64 |
| Barclay AAA Corp. | 8.65 | 8.12 | 39.32 | -3.64 | 8.01 | 28 | 4 | 0.50 |
| S&P 500 | 11.06 | 17.49 | 37.43 | -37.00 | 15.43 | 26 | 6 | 0.43 |
| Russell 2000 | 10.36 | 22.57 | 47.25 | -33.79 | 17.41 | 22 | 10 | 0.34 |
| DJ Wilshire 5000 | 10.90 | 17.91 | 36.40 | -37.33 | 15.99 | 25 | 7 | 0.41 |
| MSCI EAFE | 9.38 | 19.78 | 69.94 | -43.06 | 11.59 | 23 | 9 | 0.31 |
| Gold | 3.48 | 19.11 | 31.92 | -32.15 | 2.65 | 19 | 13 | 0.01 |
| US Inflation | 3.44 | 1.25 | 12.40 | 0.09 | 3.14 | 32 | 0 | -1.17 |
| FTSE NAREIT All REITs | 10.66 | 19.14 | 38.47 | -37.34 | 15.16 | 25 | 7 | 0.39 |
| High Yield Bonds | 10.60 | 9.66 | 54.22 | -26.17 | 10.93 | 28 | 4 | 0.63 |

Source: Credit Suisse, The Bloomberg Professional service, Ibbotson Associates

High Yield Technicals: Historical Spreads

| Monthly Credit Suisse High Yield Index Spread to Worst (bps) | | | | | | | | | | | | | Annual Performance Returns | End of Year | |
|--|------|------|------|------|------|-----|-----|-----|------|------|------|------|--------------------------------|----------------------|---------------|
| | Jan | Feb | Mar | Apr | May | Jun | Jul | Aug | Sep | Oct | Nov | Dec | Credit Suisse High Yield Index | Moody's Default Rate | Fed Fund Rate |
| 1988 | 480 | 458 | 467 | 447 | 417 | 424 | 391 | 406 | 443 | 451 | 434 | 448 | 13.66 % | 3.48% | 8.75 % |
| 1989 | 419 | 406 | 451 | 517 | 525 | 591 | 629 | 583 | 636 | 745 | 771 | 790 | 0.39% | 6.06% | 8.25% |
| 1990 | 774 | 837 | 794 | 773 | 793 | 736 | 718 | 798 | 970 | 1060 | 1058 | 1096 | -6.38% | 9.85% | 7.00% |
| 1991 | 1058 | 909 | 802 | 772 | 784 | 743 | 723 | 746 | 754 | 724 | 686 | 729 | 43.76% | 10.43% | 4.00% |
| 1992 | 589 | 538 | 490 | 500 | 499 | 521 | 544 | 555 | 563 | 583 | 532 | 548 | 16.65% | 4.94% | 3.00% |
| 1993 | 534 | 534 | 502 | 506 | 502 | 508 | 487 | 524 | 546 | 531 | 494 | 481 | 18.91% | 3.59% | 3.00% |
| 1994 | 471 | 422 | 442 | 389 | 387 | 390 | 423 | 414 | 376 | 384 | 382 | 388 | -0.98% | 1.91% | 5.50% |
| 1995 | 406 | 426 | 424 | 414 | 447 | 461 | 426 | 446 | 447 | 457 | 482 | 484 | 17.38% | 3.26% | 5.50% |
| 1996 | 473 | 426 | 418 | 402 | 385 | 417 | 398 | 375 | 383 | 404 | 412 | 355 | 12.42% | 1.64% | 5.25% |
| 1997 | 347 | 315 | 335 | 352 | 334 | 339 | 357 | 337 | 335 | 381 | 373 | 386 | 12.63% | 2.01% | 5.50% |
| 1998 | 384 | 371 | 378 | 377 | 395 | 417 | 416 | 619 | 691 | 743 | 624 | 657 | 0.58% | 3.41% | 4.75% |
| 1999 | 659 | 613 | 605 | 559 | 564 | 574 | 564 | 594 | 632 | 628 | 601 | 573 | 3.28% | 5.56% | 5.50% |
| 2000 | 581 | 608 | 668 | 671 | 714 | 728 | 733 | 773 | 829 | 837 | 949 | 959 | -5.21% | 6.05% | 6.50% |
| 2001 | 832 | 822 | 852 | 819 | 787 | 809 | 831 | 824 | 1012 | 993 | 877 | 868 | 5.80% | 10.51% | 1.75% |
| 2002 | 834 | 854 | 744 | 739 | 736 | 823 | 954 | 968 | 1064 | 1080 | 929 | 947 | 3.10% | 8.35% | 1.25% |
| 2003 | 887 | 884 | 825 | 727 | 742 | 676 | 625 | 593 | 599 | 536 | 509 | 486 | 27.94% | 5.19% | 1.00% |
| 2004 | 469 | 494 | 495 | 440 | 474 | 456 | 448 | 456 | 430 | 408 | 357 | 346 | 11.95% | 2.16% | 2.25% |
| 2005 | 354 | 307 | 373 | 431 | 430 | 406 | 353 | 379 | 377 | 393 | 398 | 388 | 2.26% | 1.93% | 4.25% |
| 2006 | 364 | 350 | 334 | 325 | 329 | 359 | 370 | 377 | 371 | 357 | 350 | 318 | 11.91% | 1.70% | 5.25% |
| 2007 | 300 | 305 | 316 | 302 | 271 | 315 | 435 | 462 | 423 | 438 | 575 | 589 | 2.65% | 0.85% | 4.25% |
| 2008 | 690 | 760 | 790 | 674 | 636 | 711 | 764 | 794 | 1000 | 1471 | 1816 | 1706 | -26.17% | 3.10% | 0.25% |
| 2009 | 1480 | 1538 | 1495 | 1214 | 1096 | 978 | 867 | 858 | 764 | 731 | 738 | 634 | 54.22% | 12.50% | 0.25% |
| 2010 | 643 | 657 | 591 | 572 | 688 | 708 | 660 | 698 | 642 | 613 | 632 | 571 | 14.42% | 3.10% | 0.25% |
| 2011 | 534 | 508 | 505 | 511 | 536 | 569 | 580 | 723 | 811 | 703 | 759 | 728 | 5.47% | 1.70% | 0.25% |
| 2012 | 680 | 624 | 621 | 629 | 699 | 660 | 640 | | | | | | 8.54% | 2.70% | 0.25% |

Average Spread: 603

Source: Credit Suisse, 2012 performance return for the index is through 7/31/2012