PACIFIC ASSET MANAGEMENT

JANUARY 2015

THE INVESTOR Compass

NAVIGATING THE CREDIT MARKETS

Loans or Bonds

In 2014, high yield bonds and bank loans produced their lowest annual returns since 2011. While both asset classes had positive returns, year-end volatility, growth concerns, a commodity selloff, and outflows negatively impacted performance. Entering 2015, given relative and absolute valuation measures, the outlook for bonds and loans is more attractive today than at any point last year. The two asset classes, however, possess unique risk profiles and could have varying roles in an asset allocation.

Table 1: Relative value favors credit risk given absolute and relative valuation measures

Index	Duration	Yield	Price	OAS
High Yield	4.17	6.46	99.40	509
Bank Loans	0.25	5.94	96.12	534
Corporate	7.35	2.78	111.26	136
Agency MBS	3.15	2.28	106.61	33
Int Corporate	4.34	2.21	106.56	111
Aggregate	5.28	1.92	107.79	51
Treasury	5.68	1.09	106.54	N/A

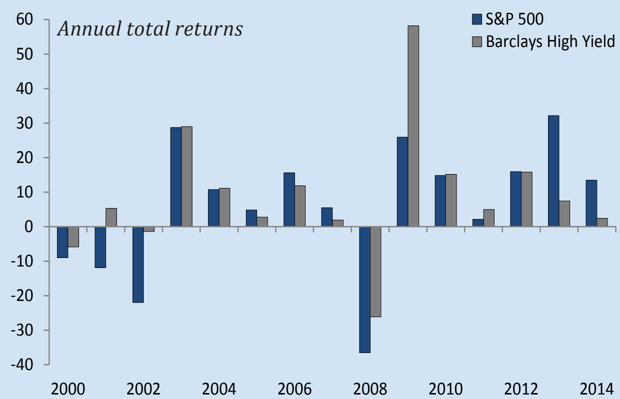
Source: Barclays, Credit Suisse, as of January 30, 2014

Current valuations make bank loans and high yield bonds attractive against the absolute low yields of traditional fixed income (table 1). Late 2014 volatility has brought yield levels to three year highs (chart 1). Average prices are now below par, with loan prices trading around $96 and high yield bonds trading around $99. The Barclays U.S. High Yield Index, which had a yield of 4.91% in June, is now yielding 6.46% as of the end of January. Given the move in U.S. Treasuries, the Option Adjusted Spread (OAS) is now at 509, the highest since June 2013. In the following six months since the index last hit this OAS, high yield bonds returned 5.95% while the Barclays U.S. Aggregate Index returned 0.43% as rates moved higher by 48bps on the 10-Year Treasury. The result was an excess return of 624bps.

Enhancing return or diversifying risk

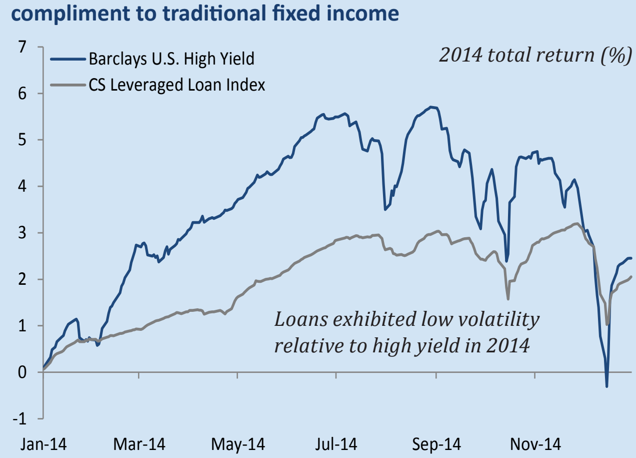
Bank loan and high yield bonds have strong relative value entering 2015. However, each market provides a unique role in an overall asset allocation.

High yield has historically been highly correlated with equity performance. High Yield bonds may participate in upside surprises in 2015 while current income may cushion downside risks relative to equities.



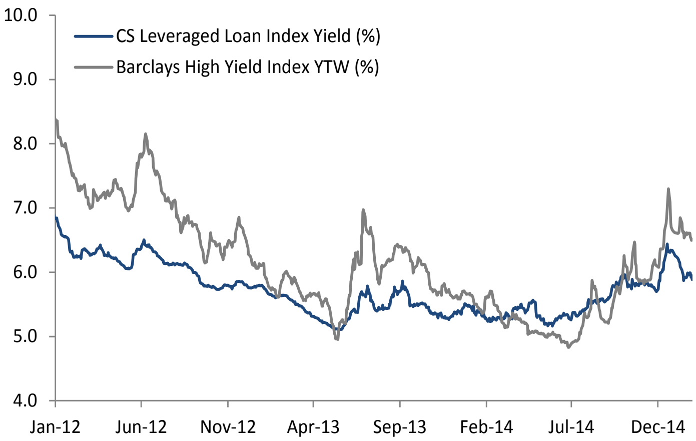
Source: Barclays, S&P, as of December 31, 2014

In contrast to high yield, bank loans may serve as a low volatility compliment to traditional fixed income



Source: Barclays, Credit Suisse, as of December 31, 2014

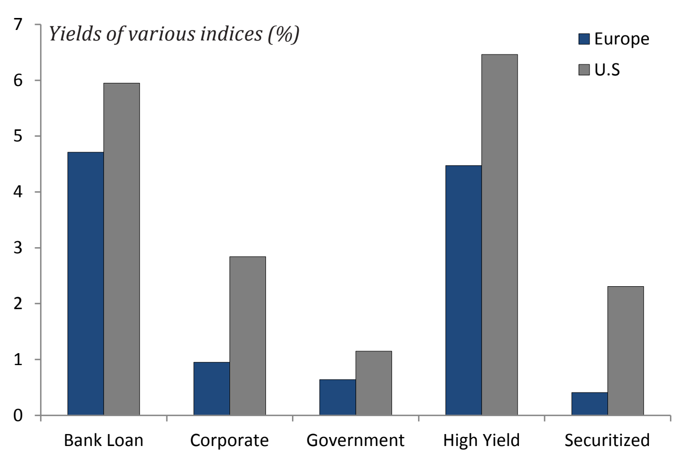
Chart 1: 2014 volatility and poor year-end technicals have left bank loan and bond yields at three year highs



Source: Barclays, Credit Suisse, as of January 30, 2014

The real question, however, is if spreads will continue to widen as government bond yields plummet and investor's risk sentiment remain finicky. At a high level, corporate health measures, improving U.S. economic activity, and a lack of upcoming maturities all point to a continuation of below average defaults. Globally, central bankers are increasing aggressiveness toward accommodative policy. The announcement of QE programs in Europe and Japan are likely to eventually be a net positive for spread products given the lack of yield opportunities elsewhere (Chart 2). Even as our Federal Reserve gets closer to increasing the overnight rate, they have shown themselves to be cautious as to ensure the rate hike would only be in the face of an expanding economy.

Chart 2: Global quantitative easing should benefit U.S. fixed income given higher yields and better fundamentals



Source: Barclays, Credit Suisse, as of January 26, 2015

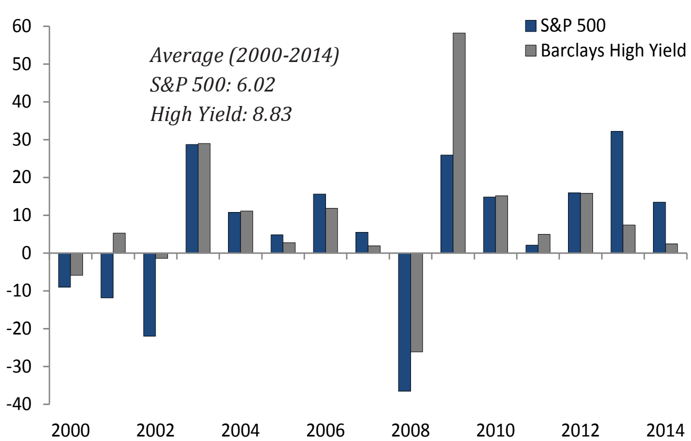
Given this backdrop, 2015 appears to be a much better entry point than seven months ago, when loans had an average price of $99 and high yield bonds were yielding below 5%. But should investors allocate to high yield or loans? To answer this, we will dig a little deeper.

High yield bonds - an odd 2014 and compelling 2015

Just how strange was 2014 for high yield? In the last 25 years, the S&P 500 has been up more than 10% in 13 of those calendar years. With the S&P 500 up 13% last year, the Barclays High Yield Index returned 2.45%, the lowest total return for high yield in any of these periods. Historically, the two asset classes have shown a high correlation (Chart 3). This correlation broke down in 2014 given high yield's exposure to energy and negative technicals.

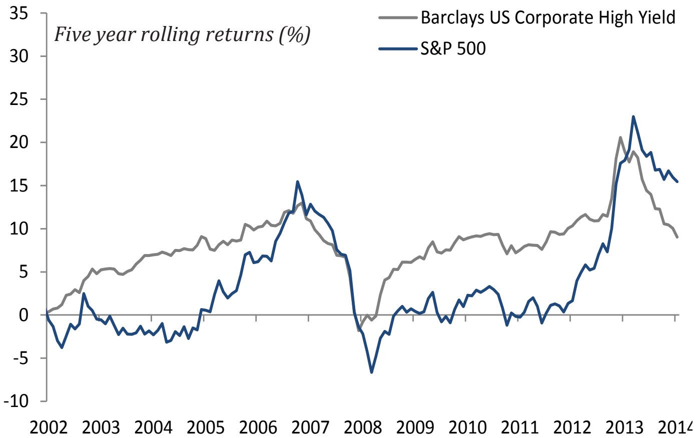
In 2015, high yield bonds are likely to be pulled by opposing forces. On the one hand, improving growth prospects in the U.S., stable balance sheets, and recent monetary policy actions abroad point to a positive credit environment and the ability for spreads to move tighter. On the other hand, high yield remains subject to higher levels of volatility, negative flows, and greater exposure to energy. With yields above 6%, low correlation with Treasuries (in particular for B and CCC rated bonds), and relatively stable balance sheets, high yield has the room to participate in upside economic or macro surprises along with equities. In addition to the reward potential, high coupon levels should help insulate downside risk, thus presenting a compelling case for high yield vs. equities entering 2015.

Chart 3: High yield has historically been highly correlated with equity performance



Source: Barclays, S&P, as of December 31, 2014

Chart 4: High yield has historically provided a lower volatility return profile through a business cycle versus equities



Source: Barclays, S&P, as of December 31, 2014

The wild card

The largest specific risk to the outlook for high yield bonds in 2015 is energy and the continued stress from the collapse in commodity prices. The high yield energy sector has grown by 133% since 2007, moving from a 6% to 14% index weighting, as U.S. debt markets have been the primary funding source for the shale gas and oil infrastructure boom. Given the higher cost and leveraged operators within high yield, $45 dollar per barrel oil may lead to a substantial default rate for some of these energy related companies. While many of these issuers have hedged oil prices in the short term, a majority of hedges roll off in 2015, exposing companies to collapsing EBITDA, free cash flow, and refinancing risk in 2016. JP Morgan estimates that at an average oil price of $65 through 2017, energy sector default rates may approach 13% over the next three years (table 2).

Table 2: Energy default rate could be significant, potentially leading to further risk aversion by market participants

U.S. energy sector default rate

Scenario	2015	2016	2017	Average
$65 average oil price	3.9%	20.5%	15.5%	13.3%

U.S. High yield index default rate

Scenario	2015	2016	2017	Average
$65 average oil price	3.0%	5.6%	5.0%	4.5%

Source: JP Morgan, estimates as of December 31, 2014

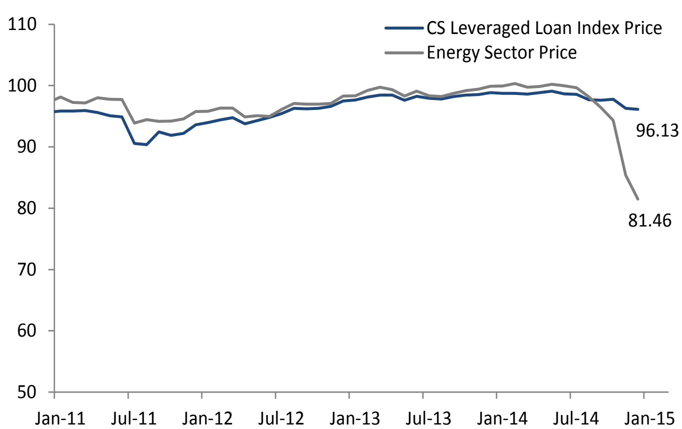
Bank Loans – a risk diversifier

Bank loan returns were below coupon in 2014, with the Credit Suisse Leveraged Loan Index returning 2.06%. In sympathy with high yield bonds, bank loan returns were underwhelming given the year-end volatility, energy selloff, and negative fund flows. Despite the relative underperformance when compared to traditional fixed income, bank loans showed low volatility in 2014. Bank loans only material weakness came in December, when poor technicals and year-end liquidity impacted the asset class. Over the past two years, during two distinct bear and bull markets for Treasuries, we have seen bank loans prove to be a low volatility complement, essentially a risk diversifier.

Supporting the low volatility outlook for bank loans in 2015 is also the limited exposure to energy. The energy sector accounts for 4% of the Credit Suisse Leveraged Loan Index versus 14% for the Barclays High Yield Index, limiting the downside risk from a continued energy related selloff and price volatility. Further, given the secured status and seniority in the capital structure, many energy loans now trade at potential recovery values, limiting downside from these price levels (Chart 5).

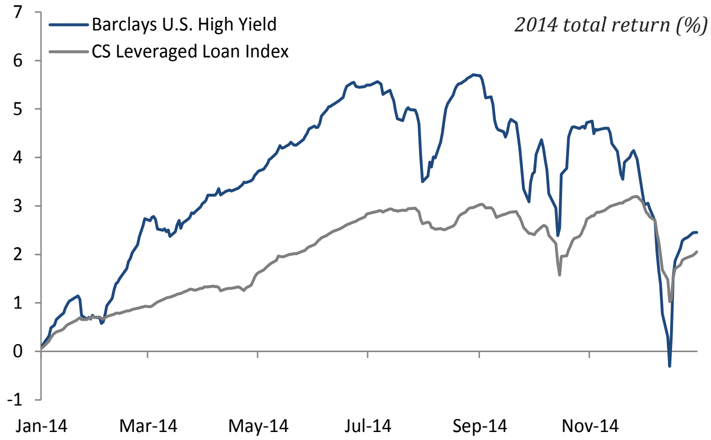
Bank loans yields are at three year highs, stable balance sheets are likely to suppress default rates, and limited duration risk gives substantial relative value versus the absolute low yield level of traditional fixed income. In our view, bank loans are attractive and a preferred complement to diversify traditional fixed income and reduce interest rate risk.

Chart 5: Only 4% of the CS Leveraged Loan Index is energy related, limiting the downside risk for bank loans from further energy related volatility



Source: Credit Suisse, as of January 29, 2014

Chart 6: Bank loans had similar returns to high yield in 2014 while exhibiting low volatility - a pattern we believe will continue in 2015



Source: Barclays, Credit Suisse, as of December 31, 2014

Loans or bonds: What's the role in the portfolio?

In 2014, credit risk was a clear loser to duration risk. As a result, high yield bonds and bank loans have a more compelling relative value starting point than at any point in the past three years. So which asset class is more compelling? In our opinion, that depends on what an investor hopes to accomplish in the portfolio. Outside of having a similar yield profile, each asset class may respond differently to various markets, giving them multiple roles in portfolio allocation.

High yield bonds, given their current valuations and historic return profile, provides the potential to participate in upside surprises via spread compression, and thus, price appreciation, while current income cushions downside risks relative to equities. For investors that are rebalancing after another strong equity year, high yield offers a compelling risk/reward profile.

Bank loans provide the ability diversify traditional fixed income risk, reduce portfolio duration, and increase portfolio yields. Also, given bank loans limited exposure to energy, we believe they will continue to provide a low volatility return profile relative to other spread based assets. For investors rebalancing fixed income portfolios after a strong year for duration based assets, bank loans may be a perfect complement.

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Pacific Asset Management • 700 Newport Center Drive • Newport Beach, CA 92660 • www.pam.pacificlife.com