FIRST EAGLE
INVESTMENT MANAGEMENT

High Yield: A Challenge and an Opportunity

Commentary
December 2015

Liquidity in the high-yield market has been a challenge over the past several quarters, as several structural factors have adversely affected traditional sources of liquidity. Historically, counterparties like banks and brokers served as market-makers, allocating capital to provide down bids in periods of market distress, as they did in 2002 and 2008/09. However, higher regulatory capital assessments pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act and tighter trading regulations such as the Volcker Rule have made it more cumbersome for them to carry out these market-making functions. As they have stepped back, individual investors have been left holding a larger share of high-yield liquidity risk. Elevated volatility is, unfortunately, an unintended consequence of such regulation.

An investment fund is only as liquid as its underlying investments. There are, today, a number of ETFs and mutual funds available in the market that focus on distressed bonds, leveraged loans or workout-situation bonds—assets that are not always fully liquid. Nonetheless, these funds are supposed to provide investors with daily liquidity.

The recent volatility in the high-yield market has been driven by the intersection of two factors: the reduced willingness and ability of banks to trade securities and the growth of investment vehicles that mismatch daily liquidity with less liquid underlying investments. Investor uncertainty regarding the timing and impact of Fed rate liftoff, the scope of the slowdown in China (and other emerging markets), and weakness in commodities (including oil) have been catalysts for the recent market weakness. We believe that the price movements have been magnified due to the seasonal decrease in trading activity that historically occurs post-Thanksgiving and extends through year end. The high-yield market experienced a similar trading environment late last year. When volatility becomes elevated, there are usually opportunities to pick up attractively priced assets that have been punished in the sell-off.

At First Eagle, we have prepared for a period of rising volatility and, possibly, constrained liquidity by constructing our portfolio from the bottom up and focusing on securities that meet stringent standards for cash flow, asset coverage and covenant quality. While we do have exposure to the energy sector and we do own some distressed securities, we believe one of the keys to sustained success in the high-yield market is to avoid defaults and collect coupons.

We do not believe that the credit cycle is about to enter the bear-market phase because we haven't yet seen the swift erosion in investor underwriting standards that typically precedes a period of rapidly rising defaults. That said, we are holding more cash and intend to take advantage of market volatility by adding to existing holdings at what we consider attractive yields. Additionally, we have stress-tested the portfolio from a days-to-liquidate perspective, and we believe that our holdings are sufficiently liquid in this environment.

Funds that invest in bonds are subject to interest-rate risk and can lose principal value when interest rates rise. Bonds are also subject to credit risk, in which the bond issuer may fail to pay interest and principal in a timely manner, or that negative perception of the issuer's ability to make such payments may cause the price of that bond to decline.

The Fund invests in high yield securities (commonly known as "junk bonds") which are generally considered speculative because they may be subject to greater levels of interest rate, credit (including issuer default) and liquidity risk than investment grade securities and may be subject to greater volatility. The Fund invests in high yield securities that are non-investment grade. High yield, lower rated securities involve greater price volatility and present greater risks than high rated fixed income securities. High yield securities are rated lower than investment-grade securities because there is a greater possibility that the issuer may be unable to make interest and principal payments on those securities. All investments involve the risk of loss.

Bank loans are often less liquid than other types of debt instruments. There is no assurance that the liquidation of any collateral from a secured bank loan would satisfy the borrower's obligation, or that such collateral could be liquidated.

There are risks associated with investing in funds that invest in securities of foreign countries, such as erratic market conditions, economic and political instability and fluctuations in currency exchange rates. Funds whose investments are concentrated in a specific industry or sector may be subject to a higher degree of risk than funds whose investments are diversified and may not be suitable for all investors.

The commentary represents the opinion of the High Yield Team Portfolio Managers as of December 2015 and is subject to change based on market and other conditions. The opinions expressed are not necessarily those of the firm. These materials are provided for informational purpose only. These opinions are not intended to be a forecast of future events, a guarantee of future results, or investment advice. Any statistics contained herein have been obtained from sources believed to be reliable, but the accuracy of this information cannot be guaranteed. The views expressed herein may change at any time subsequent to the date of issue hereof. The information provided is not to be construed as a recommendation or an offer to buy or sell or the solicitation of an offer to buy or sell any fund or security.

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