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The Credit Conundrum

How can fixed income investors meet their return objectives in a low yield world?

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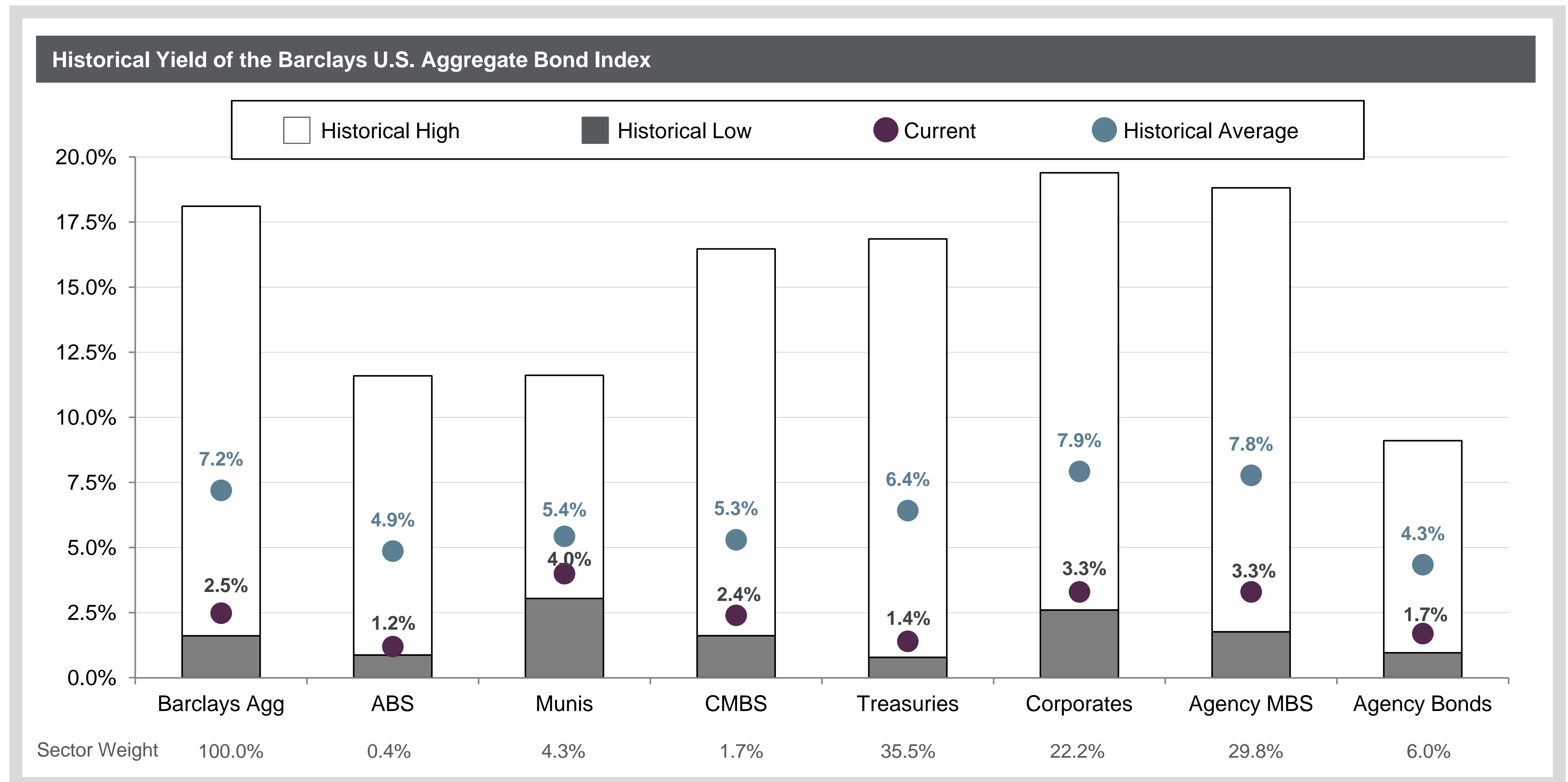
Traditional Yield Strategies

Monetary Policy Contributing to Scarcity of Yield Across Fixed Income Landscape

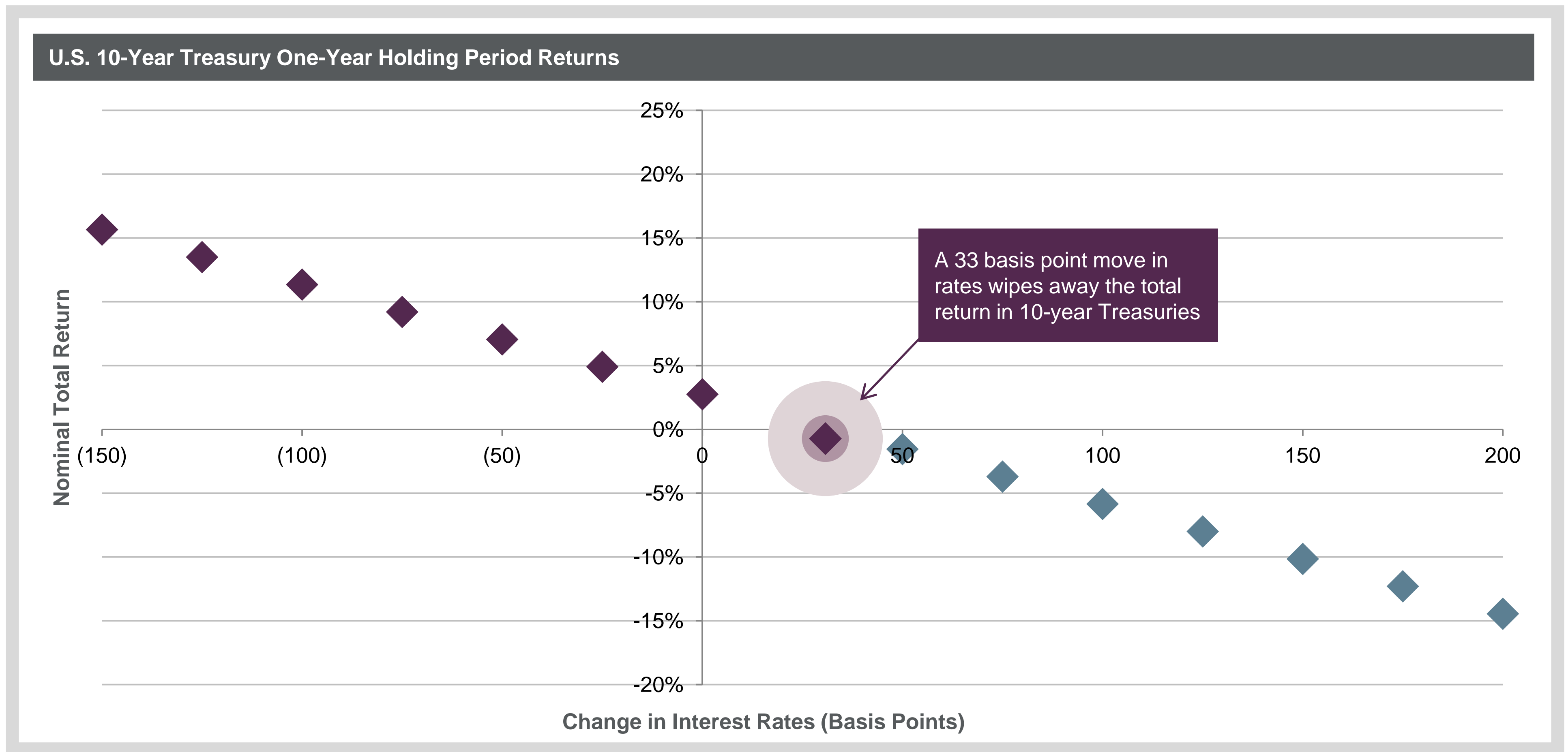
- With the Barclays U.S. Aggregate Bond Index at 2.5%, and each index subsector yielding less than 4%, investors face a scarcity of yield across the fixed income landscape
- While extending duration or adding leverage to meet yield objectives may prove successful in the near term, utilizing these investment shortcuts may carry significant long-term risks



Source: Barclays. Data as of 12.31.2013. Historical average based on available Barclays data. For Barclays U.S. Aggregate and Agency MBS since January 1976; Treasuries, and Corporates since January 1973, ABS since December 1991, Munis and Agency Bonds since January 1994, and CMBS since July 1999.

Era of “Return-Free Risk”

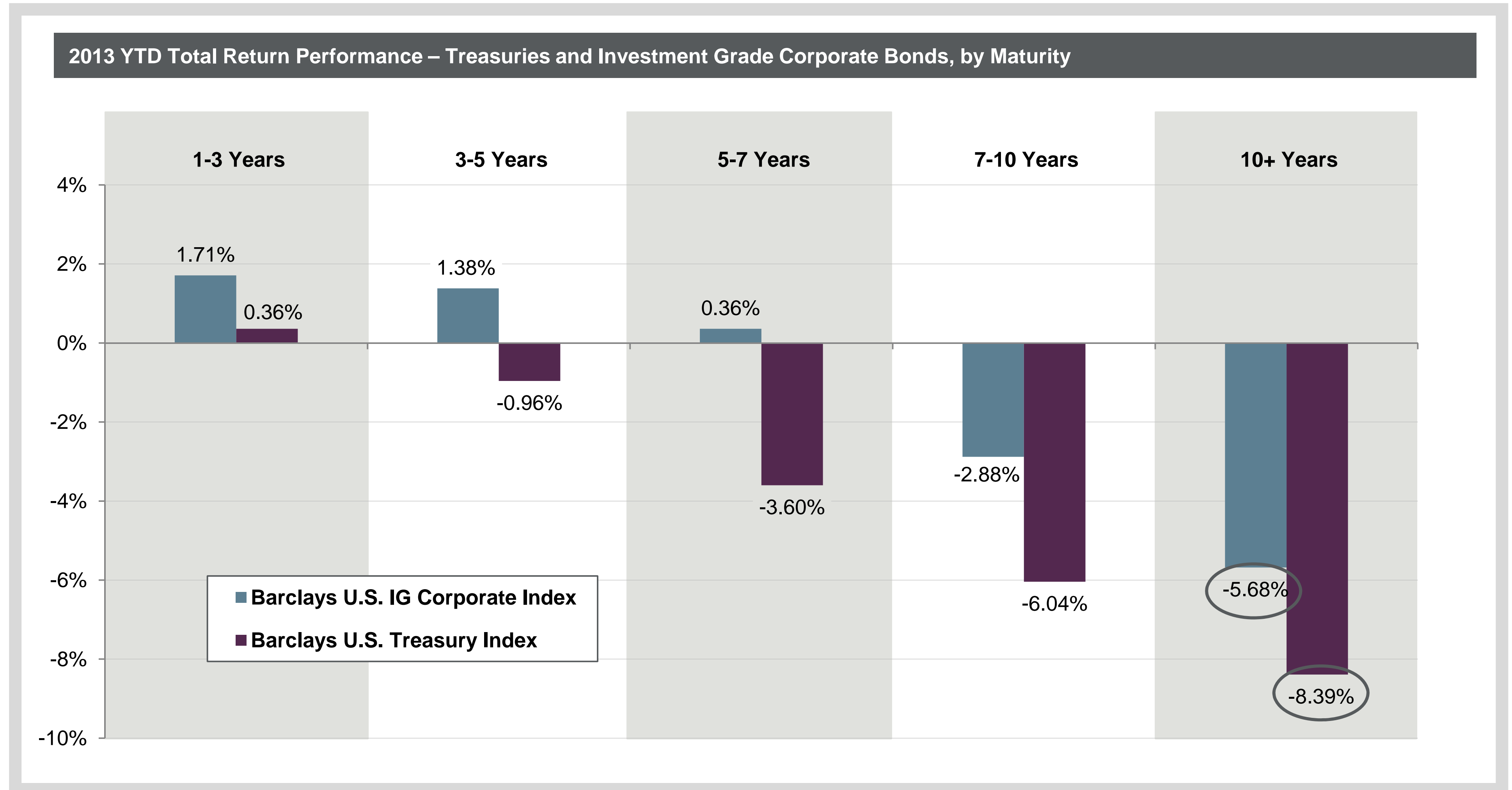
- At current coupon rates, a 33 basis point rise in rates would lead to a negative total return over a one-year holding period
- With the risk in Treasuries heavily skewed to the downside, we believe Treasuries have gone from offering “risk-free returns” to now effectively becoming “return-free risk”



Source: Bloomberg. The total return scenario is calculated based on the coupon rate of 2.75% and an effective duration of 8.6 years.

Extending Duration Has Led to Underperformance: 2013 YTD Returns

- As monetary policy is likely to continue influencing the performance of bond markets, optimal positioning on the yield curve has become paramount
- Longer maturity bonds, which exhibit the greatest sensitivity to interest rates, have underperformed, with large, negative total returns in 2013

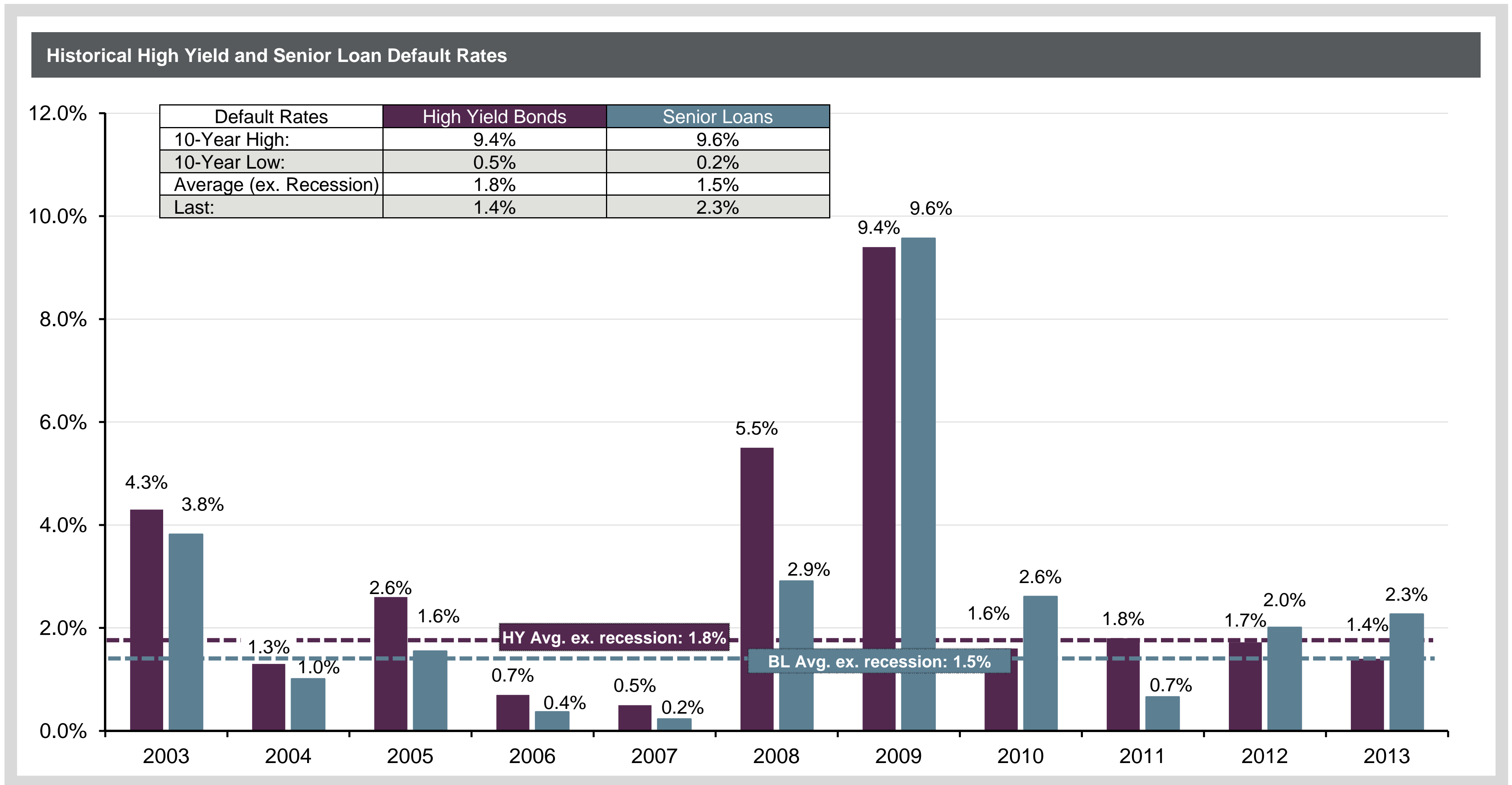


Source: Barclays. Data as of 12.31.2013. Performance for 10+ year Treasuries excludes maturities greater than 20 years.

Monetizing Complexity

Corporate Default Rates Remain in Line with Historical Averages

- Since 2010, annual default rates have remained in line with historical averages during previous non-recessionary periods
- Stronger balance sheets and sustained monetary accommodation should keep default rates low over the near term



Default Rates	High Yield Bonds	Senior Loans
10-Year High:	9.4%	9.6%
10-Year Low:	0.5%	0.2%
Average (ex. Recession)	1.8%	1.5%
Last:	1.4%	2.3%

Source: Credit Suisse. Default rates represent 12-month trailing default rates. Average default rates are from 2003 to 2013, excluding recessionary period between 2008 - 2009. Data as of 10.31.2013.

Identifying Market Segments Where Investors can Create Value

- Smaller debt tranches offer significant yield pickup in high yield bonds and senior loans over similarly-rated, larger debt tranches
- Offers investors the opportunity to drive deal terms – much less common in larger deals

Barclays Corporate High Yield Index

Size ($mm)	Market Weight	Yield to Worst
< 300	11.93%	6.27%
300 - 400	10.88%	5.99%
400 - 500	10.02%	5.47%
500 - 750	21.91%	5.06%
750 - 1000	12.25%	4.98%
>= 1000	33.02%	5.18%

Credit Suisse Leveraged Loan Index

Size ($mm)	Market Weight	Discount Margin to Maturity
< 300	13.39%	713
300 - 400	9.60%	561
400 - 500	6.34%	481
500 - 750	14.57%	476
750 - 1000	10.34%	487
>= 1000	45.75%	450

Source: Barclays data as of 10.31.2013. Barclays Corporate High Yield Index excludes bonds trading at a price below 80.

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