BLACK BEAR
VALUE PARTNERS

"HIGH YIELD" ETF'S: LOOKING GOOD FROM FAR BUT FAR FROM GOOD

June 2018

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INTRODUCTION TO BLACK BEAR VALUE PARTNERS, LP

"An investment in knowledge pays the best interest." – Benjamin Franklin

Overview

- Black Bear Value Partners is an a fundamental and value-oriented investment manager approach highlighted by certain attributes:
  - Preservation of capital
  - Understandable ideas
  - High margin of safety
  - Contrarian approach
  - Concentrated portfolio
  - Industry and asset class agnostic

Investment Philosophy

- Significant personal investment
- Invest with a margin of safety
- Capital preservation is critical
- Lower fees
- Performance driven culture
- Longer term capital base
- Patience and disciplined capital allocation

Portfolio Manager

- Led by Adam Schwartz, a 14 year professional buy-side investment analyst with extensive experience across a wide range of asset classes and investment themes including equities, structured credit, corporate credit, capital structure arbitrage and real estate
- Adam was a senior member of the investment team and a Director at Fir Tree Partners, a $13BB AUM investment manager from 2007-2015
- Partners will have a significant amount of their investable net worth invested in the Fund

QUICK RECAP ON LAST YEAR

- Discussed AutoNation @ $41 a share
- What has happened?
  - Top-line flattish with minor margin expansion as P+S and F+I grew (higher margin) and car sales slowed (lower margin)
  - Bought back ~9% of the company with stock in low 40's
    - Bought back half the company since 2007 at avg. price of $30
  - Partnering with Waymo
  - Beneficiary of new tax plan
  - Always things to worry about:
    - Rising rates & impact on floorplan/customer affordability
    - Make sure there is no WFC issue with F&I growth
    - P&S growth has been slower than expected

CREDIT ETF'S – LOOKING GOOD FROM FAR BUT FAR FROM GOOD

- Why do people think they like bond ETF's?
  - Bonds don't lose money
  - ETF's are super-liquid
  - Low (ish) fees and passive
  - Positive carry – 5%+ coupons
  - Diversity from equities
  - Individual bonds are hard to buy for retail
- Like our friend over here…. these securities clean up well but can be lethal
- We are short a variety of fixed income ETF's both outright and through options

ROUGH STATS ON HY ETF'S

- ~6% yield
  - ~4 year duration
  - ~350 bps spread to treasuries assuming NO losses

- Assuming historical losses of 2% **yield is ~4%**
  - 150 bps spread

- Credit breakdown:
  - 43% BB
  - 42% B
  - 13% CCC or lower

- Sample credits:
  - Altice – 5.5x EBITDA / 10.9x OCF
  - Sprint – 2.8x EBITDA / 3.2x OCF
  - First Data – 6.3x EBITDA / 8.5x OCF
  - Frontier – 4.9x EBITDA / 9.6x OCF

HOW DOES THE SAUSAGE GET MADE?

"What?! Not even one of you wants to see how they're made?"

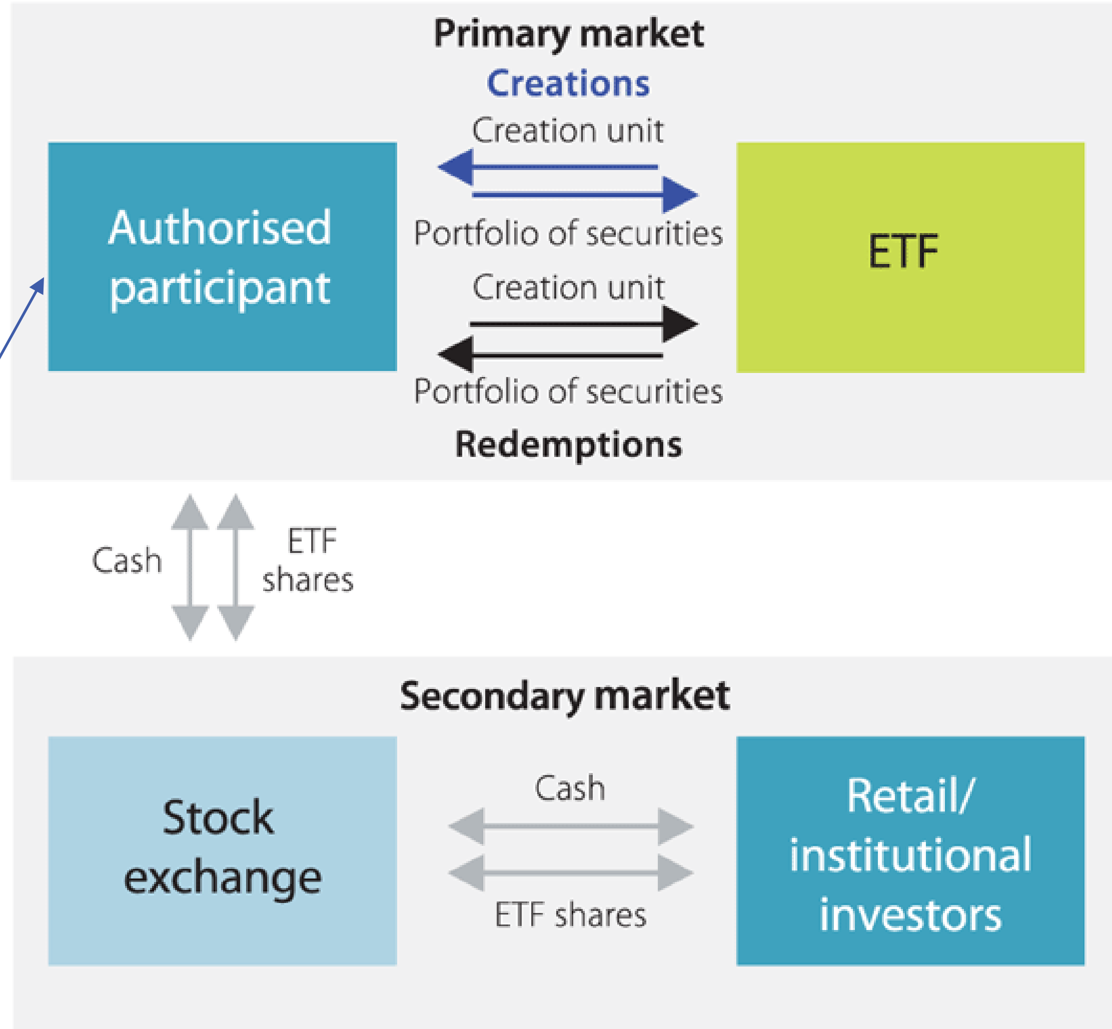
HOW DOES THE SAUSAGE GET MADE?

- Bonds are issued by companies and borrow your money
- They promise to pay you back principal with interest and create rules called covenants - examples of covenants and rules in an indenture are:
  - How much they can borrow?
  - Seniority of claims
  - Interest coverage
  - Restricted subsidiaries and asset pledging
  - What happens if they sell assets – where does the cash go?
- The bonds are sold to investors – ex. ETF's buy them and stick them in their structure

HOW DOES THE SAUSAGE GET MADE?

- Buying bonds and ETF's requires cash – in good times cash is plentiful
- Selling an ETF requires liquidity for the ETF
- ETF's selling bonds requires bids for bonds…<u>during rocky times credit markets are not always liquid</u>
- If an ETF trades at a discount to NAV, market makers are supposed to "arb" and close the discount – <u>this only works if there is liquidity in the cash bond market.</u>

ETF Creation and Redemption Process



Source: RBA

SLEEPING AT NIGHT – DAILY LIQUIDITY!

- What happens if there is limited liquidity for the underlying cash bonds?

- What happens when people expect an asset to have liquidity (the ETF) when the underlying asset (the bonds) are less liquid?

- Who will the market makers sell their bonds to?
  - Limited bank balance sheets/prop desks

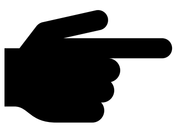
- <u>NAV's may not be trusted and the discount to NAV could be substantial – creates circular trust issue</u>

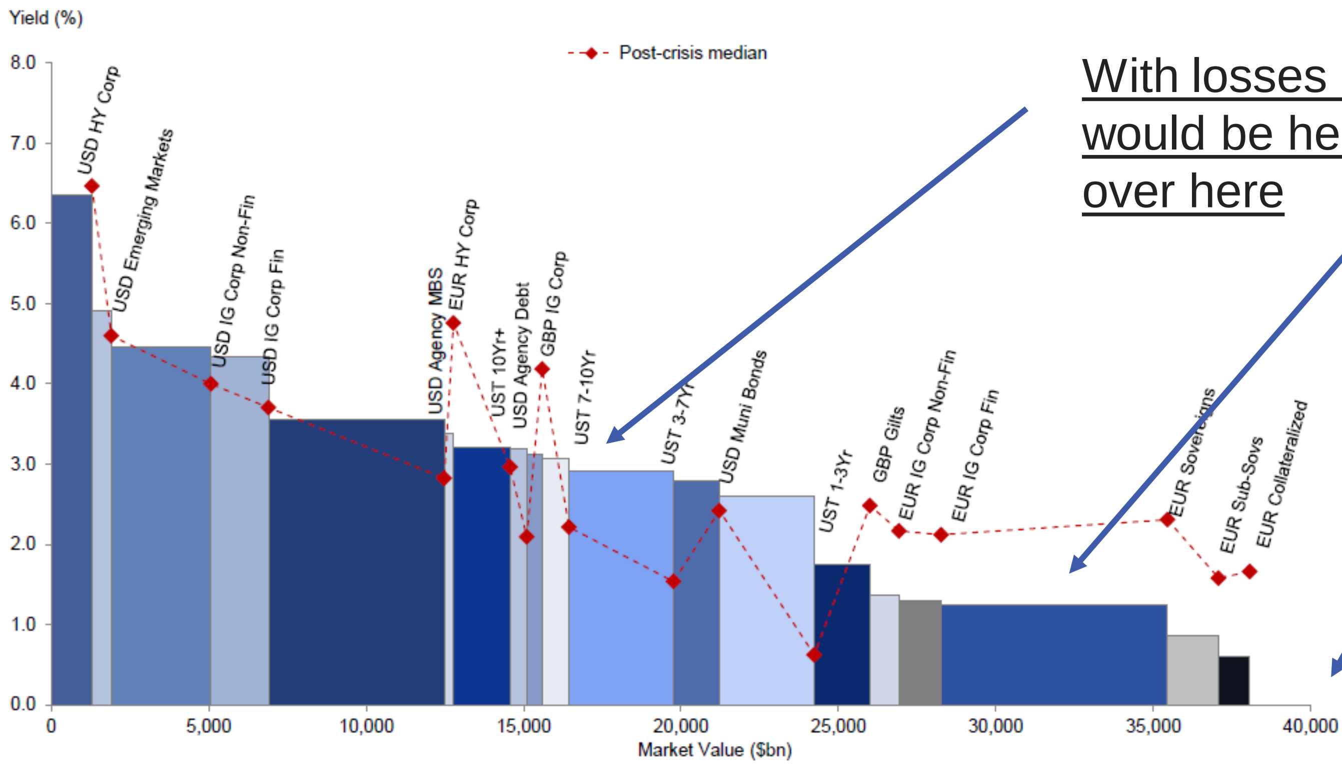
HY AND FIXED INCOME ALTERNATIVES

- HY appears to yield 6+% but assumes no losses (with losses it's ~4%)

Yields across global fixed income markets

Exhibit 44: Average yield vs. total market value outstanding for USD, EUR, and GBP fixed income markets





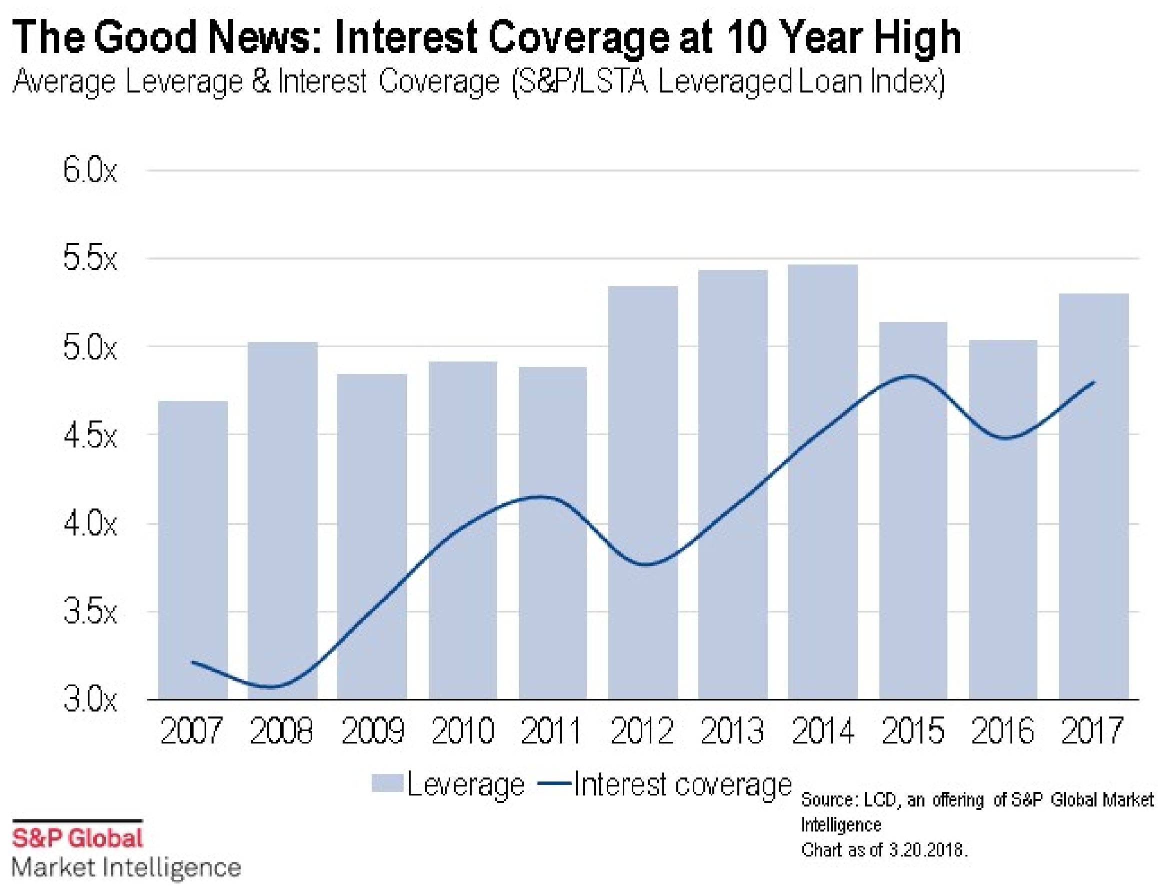
With losses bonds would be here or maybe over here

Source: iBoxx, Bloomberg Barclays, Goldman Sachs Global Investment Research

INTEREST COVERAGE

- Higher interest coverage and easy refinancing has allowed the can to be kicked down the road

- Rising rates and companies will need to refinance – will the can kick back?

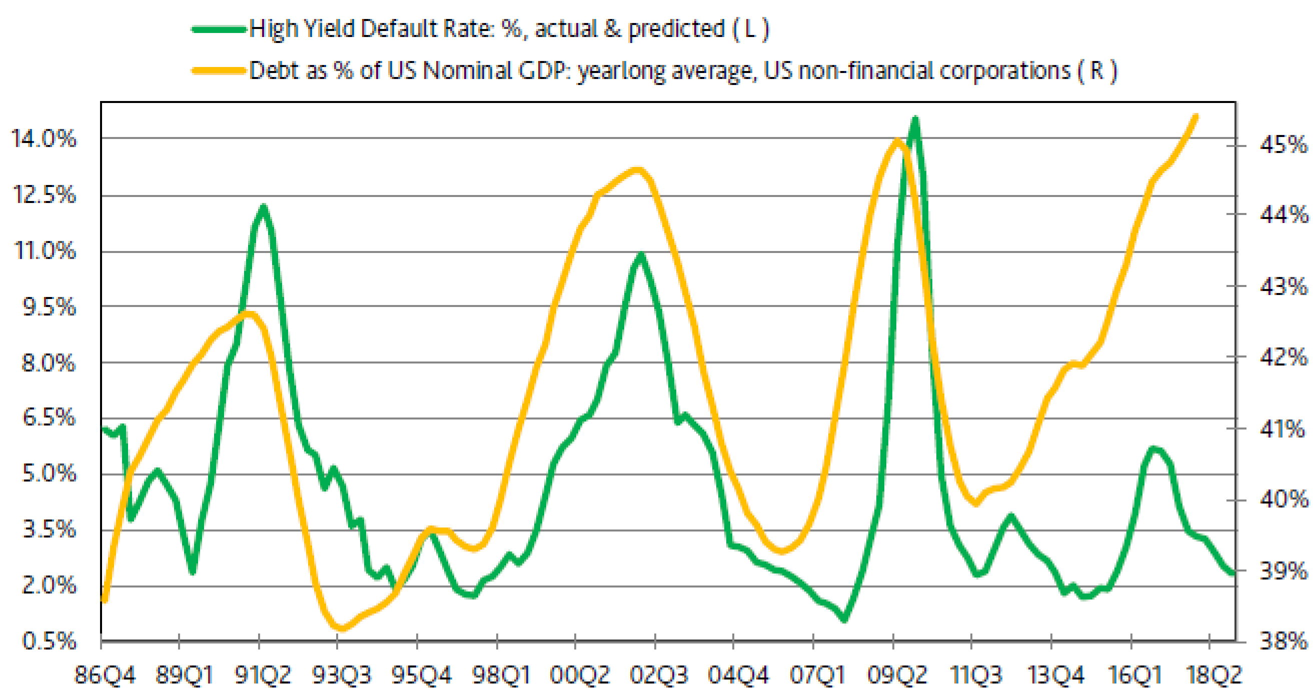


RISK/REWARD

- More debt usually means more losses but recent history and expectations are less losses.

  - Debt = yellow - HIGHER
  - Default = green - LOWER

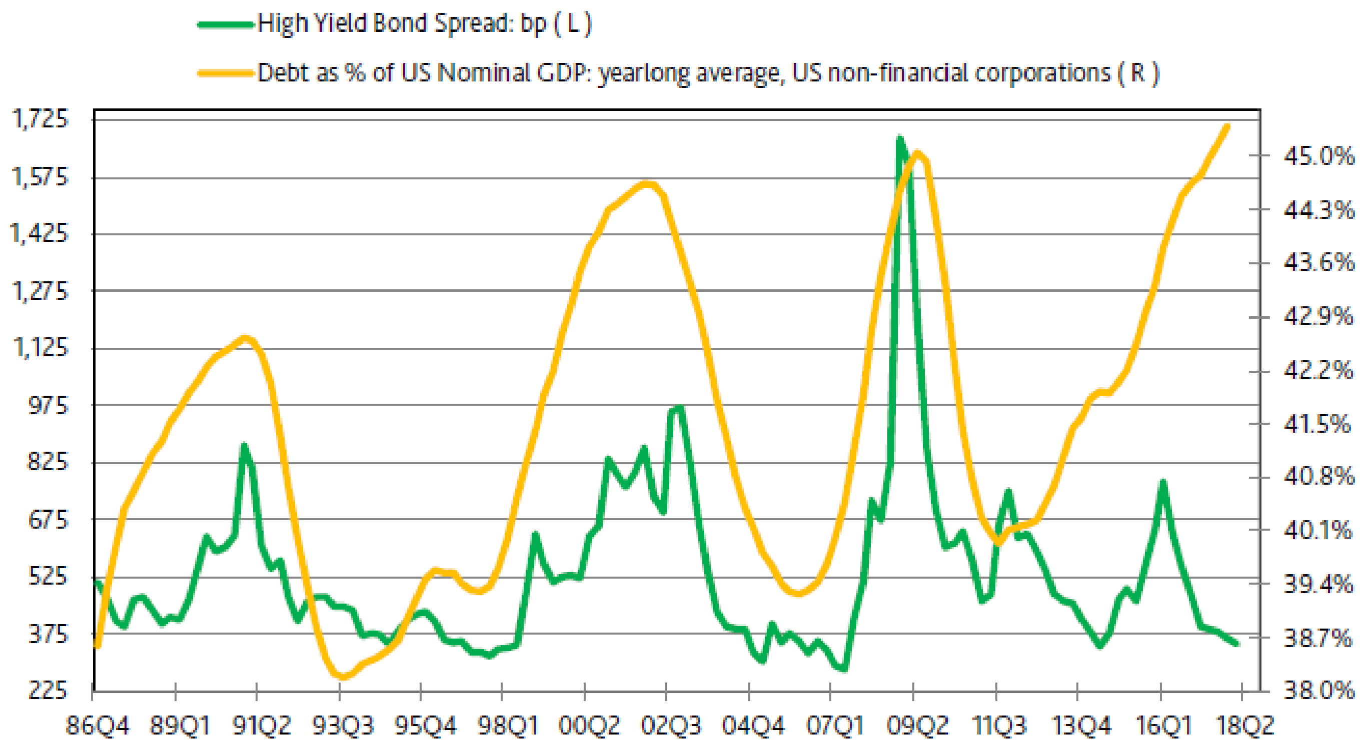
Figure 2: Recent Default Rate and Its Projected Trend Defy Record Ratio of Corporate Debt to US GDP
sources: Moody's Analytics, Federal Reserve



MORE RISK…BETTER RETURN?

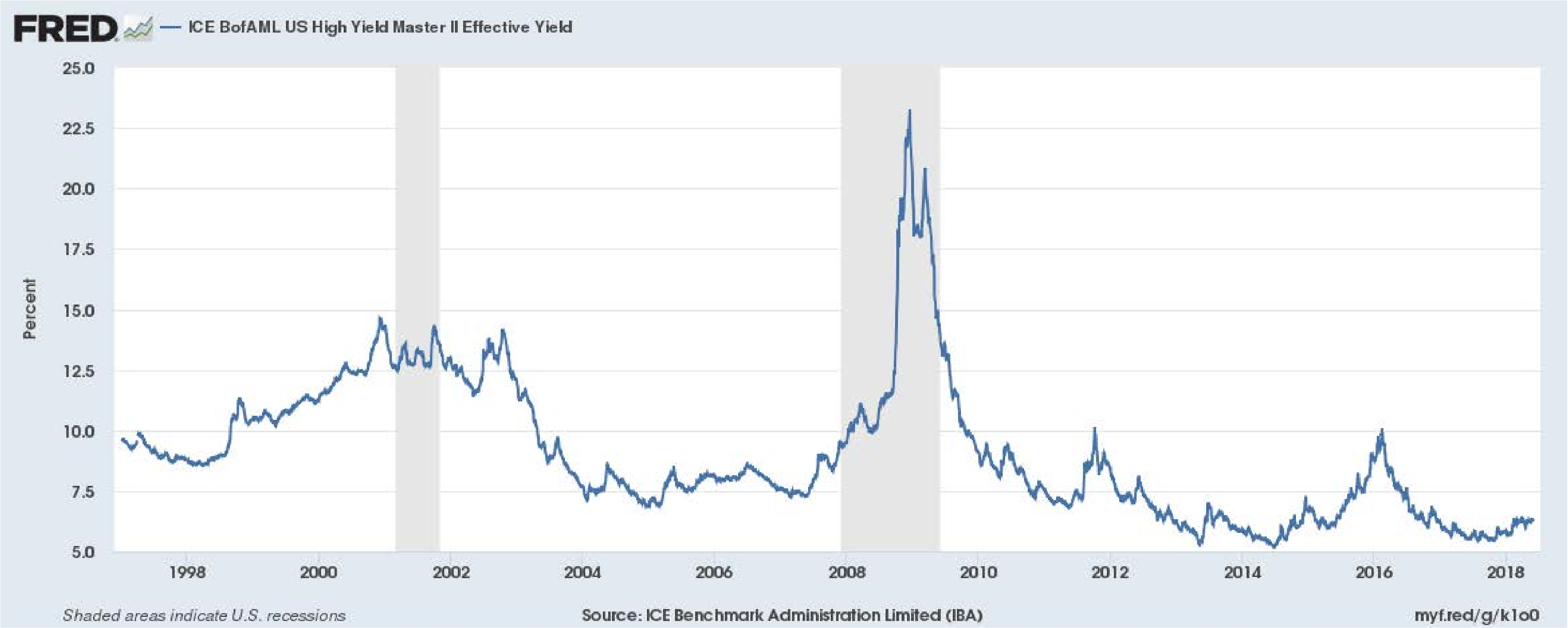
- Do we get paid a higher return for more debt….NOPE!
  - Debt = yellow =HIGHER
  - Green = HY spread = LOWER

Figure 3: Ultra-Thin High-Yield Bond Spread Shrugs Off Record Ratio of Corporate Debt to US GDP
source: Moody's Analytics, Federal Reserve



HISTORY OF YIELDS

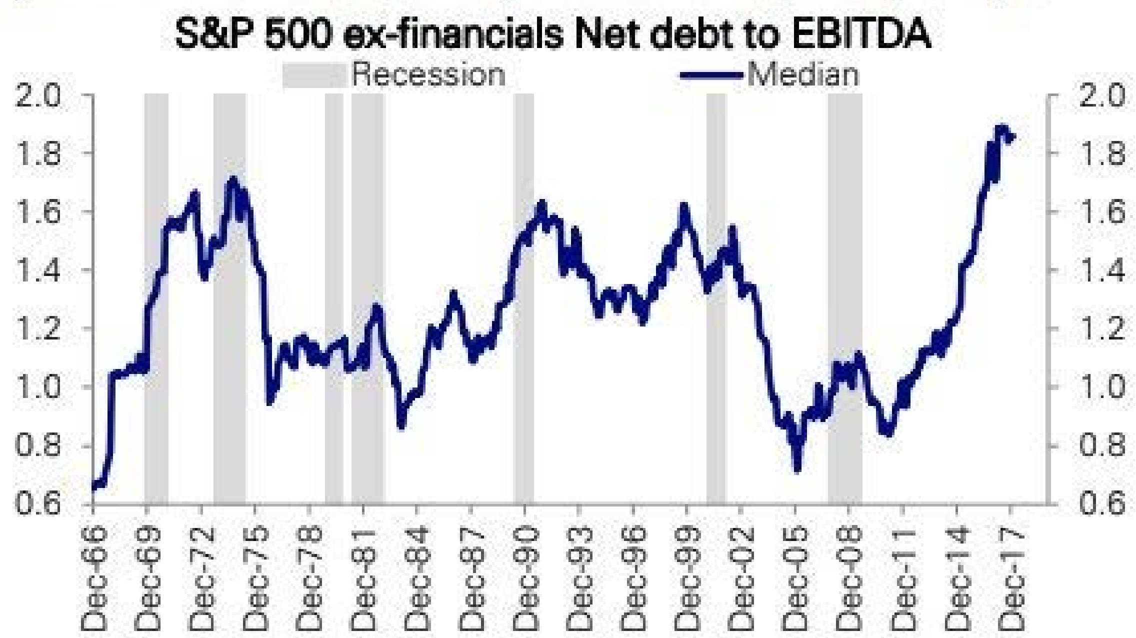
- Yields are close to all-time tights



COMPANIES ARE BORROWING A LOT!

- Leverage is at a 50 year high

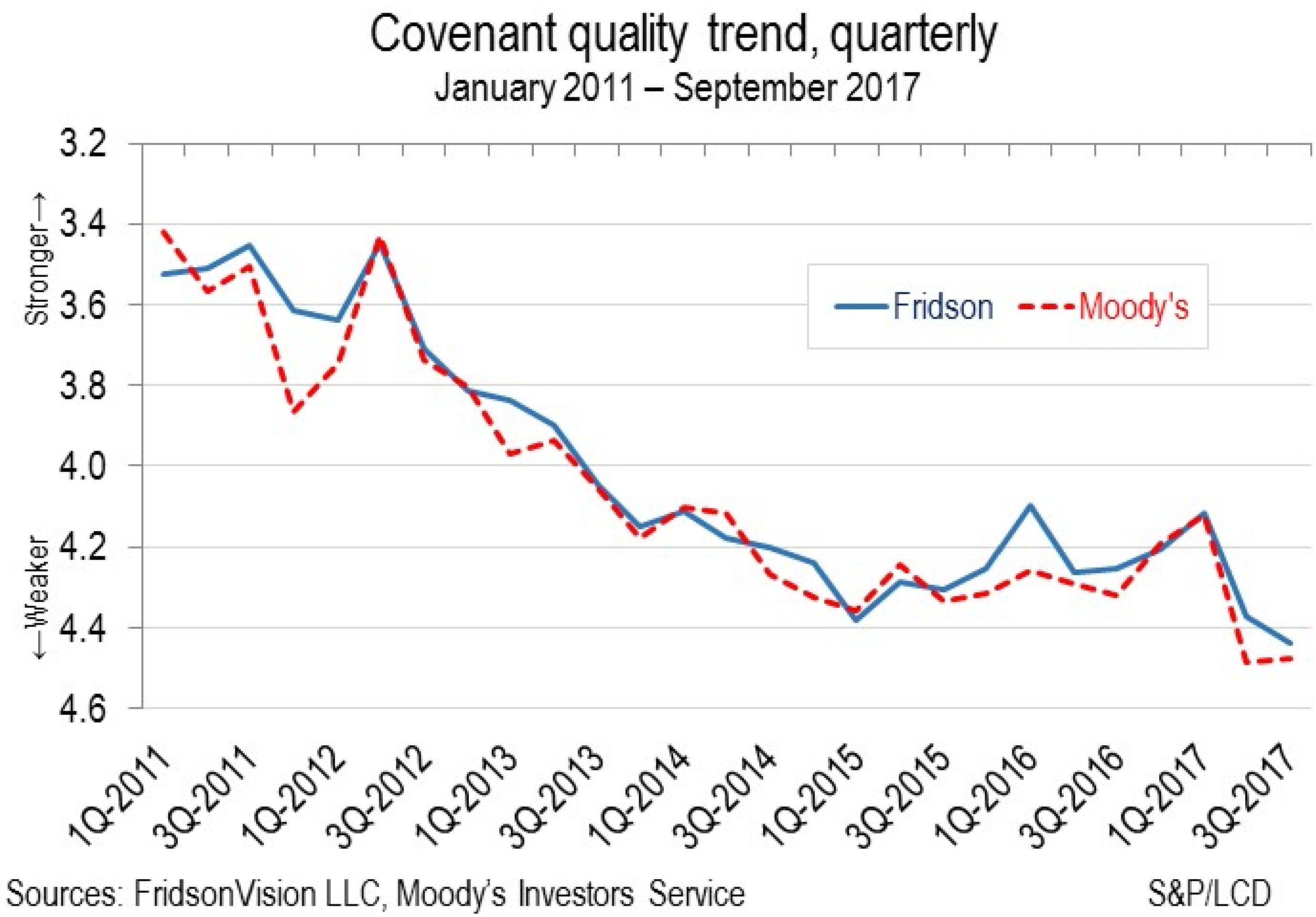
Figure 12: Median company leverage has risen sharply to 50 year highs



Source: Compustat, Deutsche Bank

WEAK COVENANTS

- The quality of the “promises” have been getting worse and worse



SOME SIMPLIFIED BOND CONCEPTS

- The duration of the bond is price sensitivity to a change in rates
  - A bond with a duration of 4 should decline by 4% for a 100 bps rate change
  - <u>Works for small changes in rates</u>
  - It is the 1st derivative of the price-yield relationship

- Convexity is the price sensitivity to larger moves in rates
  - This is the 2nd derivative of the price-yield relationship

- Why does it matter? If there is a big move in rates, the price will drop MORE than the duration implies...

- People have a hard time with non-linear outcomes (i.e. not smooth) – if liquidity/returns/losses/expectations are poor…the returns to the down could be non-linear.

CREDIT SHORT UP/DOWN

- High level assumptions
  - 1Y Up/Down – could take longer which means it costs more…bad for the short
  - Net losses on bonds ~2%
  - US Treasury widen by 0 bps/+100 bps/+150 bps
  - Credit spreads widen by 0 bps/+400 bps/+600 bps
  - Cost of carry is ~6% per annum
  - An “orderly” sell-off results in the duration math working
  - “Not orderly” sell-off results in some bond convexity

CREDIT SHORT UP/DOWN

- Options can provide more leverage somewhat similar to ABX (5-10+ to 1)

1Y Up/Down							
	ORDERLY				NOT ORDERLY		
	Down	Base	Up		Down	Base	Up
Current Net Yield	4.0%	4.0%	4.0%		4.0%	4.0%	4.0%
Duration	4.0	4.0	4.0		4.0	6.0	6.0
Current 5Y UST Yield	2.8%	2.8%	2.8%		2.8%	2.8%	2.8%
Current Spread to 5Y UST	1.2%	1.2%	1.2%		1.2%	1.2%	1.2%
UST Yield Change	0.0%	1.0%	1.5%		0.0%	1.0%	1.5%
Spread Change	0.0%	4.0%	6.0%		0.0%	4.0%	6.0%
Implied 5Y YST Yield	2.8%	3.8%	4.3%		2.8%	3.8%	4.3%
Implied Net Yield	4.0%	9.0%	11.5%		4.0%	9.0%	11.5%
Implied Spread to UST	1.2%	5.2%	7.2%		1.2%	5.2%	7.2%
New Bond Px	100	80	70		100	70	55
Carry	-6	-6	-6		-6	-6	-6
Total PNL	-6	14	24		-6	24	39
P/L% - Simple	***-6%***	***14%***	***24%***		***-6%***	***24%***	***39%***
Note: Not Orderly assumes some element of convexity so duration expands by 50% to 6.							

CONCLUSION/Q&A

- If/when people's unrealistic expectations are missed, the credit ETF machine could break down and lead to unfortunate and avoidable outcomes

- Questions?

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