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High Yield Commentary

Third Quarter 2011

Market Review

The U.S. high yield market retreated 6.10% in the third quarter (Barclays Capital U.S. High Yield Constrained Index), bringing the year-to-date return into the negative territory, at -1.42%. As risky assets underperformed in the second quarter, the high yield market performed better than only U.S. equities (-13.87%), trailing all other credit asset classes, including crossovers (-2.66%), emerging market bonds (-2.91%), investment grade bonds (3.03%) and U.S. government bonds (5.85%).

Market softness late in the second quarter extended into July, as the U.S. debt ceiling issue and European sovereign crisis left investors jittery. Helped by better-than-expected second-quarter earnings, the high yield market had little spillover effect from the macro overhangs and returned 1.15% in July. Double-dip fears arose again in August, as we received disappointing GDP and ISM numbers, despite the passing of the debt ceiling extension. The high yield market recorded its eighth worst total return in history, at -4.02%. The negative sentiment went on into September, when liquidity became difficult and market volatility spiked. The high yield market sold off another -3.29% during the month.

U.S. high yield corporate spreads widened 276 bps, from 571 bps June 30 to 847 bps September 30. The high yield market reached its tightest level of 498 bps since the end of 2007 on April 11. Spreads are now about 300 bps wider than the long-term average of 550 bps.

The yield to worst for the high yield market ended the third quarter at 9.54%, which is 202 bps wider than the yearend level of 7.52% and the widest level we have seen since the end of 2009.

New issue volume dropped significantly in the third quarter, after $110.3 billion of new issues were priced in the second quarter. August and September together saw less than $10 billion of new issuance, and the quarter recorded a total of $26 billion. Only $1.6 billion was non-USD issuance, according to J.P. Morgan. Year to date, $250.6 billion of new issues came to the market. The third quarter's new issues were generally higher in quality.

On the demand side, investors moved their money out of risky assets and into safe-haven securities such as Treasuries. The high yield market had an outflow of $2.8 billion during the third quarter, bringing the year-to-date inflows down to $2.2 billion. For comparison, 2009 and 2010 recorded $33 billion and $13 billion of inflows, respectively.

During the quarter, higher quality bonds outperformed lower qualities, as investors peeled back their risky positions. BBs returned -3.76%, while Bs returned -5.23%, and CCCs returned -11.73%.

Energy and consumer non-cyclical sectors had the best returns in the third quarter, at -2.96% and -4.03%, respectively. Among individual issues, Petrohawk, which was acquired by BHP Billiton in July for $12.1 billion, recorded the highest return, at 10.32%. Financials continued to underperform the broader market. Banking, led by Bank of America, was down 11.18% during the quarter.

The Moody's Investors Service U.S. issuer-weighted default rate continued its downward trend and reached 1.8% at the end of August, its lowest level since the third quarter of 2008 and down from the November 2009 peak of 13.48%. Moody's forecasts the default rate to decline to 1.5% by the end of 2011 and to rise slightly to 2.2% in 12 months.

The high yield rating trend remains positive, despite deteriorating from previous quarters. The number of upgrades outpaced the number of downgrades in the third quarter, at 68 to 59 on an issuer basis and $344 billion to $191 billion on a volume basis, according to J.P. Morgan.

Outlook

Throughout the third quarter, the market was dictated by headline news around the potential Greece default and the global economic slowdown. The high yield market ended the quarter in negative territory on a year-to-date basis, with +5.65% attributable to coupon return and -7.08% attributable to price return.

We think the market will remain volatile until we see clarity on the European sovereign issue. Liquidity remains at a premium in the high yield market due to continued outflows and little primary market activity.

We are still positive on the fundamentals of the U.S. economy and corporations, however. The balance sheets of U.S. corporations are doing well after just coming out of a recession and before having a chance to lever up. Corporate earnings have been strong, and we see

strength in top-line growth, as well. The ISM was at 51.6 in September, indicating expansion in the manufacturing sector. With commodity prices coming down, we could see consumer spending pick up.

We think valuations also are attractive at this level. Spreads at the 900-bps level imply a default rate of more than 6%, which is almost three times higher than the Moody's 12-month default forecast. We think current valuations have priced in a recession, which we do not currently foresee.

We believe that the best risk and return profiles are not from an outright add to the riskiest and highest yielding credits, but from fundamentally strong companies that can realize the earnings from an economic recovery and weather any macro volatility should the market pull back. We continue to recommend an overweight to BB and B rated bonds over CCC credits. We believe security selection will be the key to outperformance during this volatile time. We would like to reiterate our recommendation of a marketweight to the high yield asset class.

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