



The PMs' Perspective

Edward Meigs and Sean Slein Discuss Investing in High Yield

Ed Meigs and Sean Slein Discuss Investing in High Yield is the third issue of *The PM's Perspective*, a series of interviews with senior members of First Eagle's investment teams. As a firm with a long tradition of independent thinking, we invite you to read market views and strategic insights that come straight from our investors.

Q: Why high yield, and why now—particularly in today's volatile environment?

Sean: We believe that there's value in high yield in today's environment, with spreads in the area of 750 basis points over Treasuries. An important fundamental concept about the high-yield cycle is that at every stage, investors are responding to the historical environment—what has been happening in their recent memory—*not* what is happening in the current environment. For example, the implied default rate at this point is somewhere in the six- to eight-percent area—versus the last 12 months' default rate of approximately two percent.

So the market right now is factoring in a mild recession. With spreads as they are, we feel that we're being adequately compensated for the investments we have in the portfolio even if a mild recession were to occur.

The environment for high yield today is a lot different than it was back in 2006–2007—years when spreads were very tight. Companies have generally focused on repairing their balance sheets and also modifying their cost structure, so they're in a much healthier financial condition. High yield issuers have generally been using the proceeds from the primary market to refinance their debt, not to leverage transactions. So gen-

eral market leverage is a lot lower than it was three or four years ago. You don't have many synthetic collateralized loan obligation (CLO) or collateralized bond obligation (CBO) type of transactions as leveraged structures driving spreads tighter. So, in general, we believe the market environment is much better today than it was three or four years ago.

Ed: We're certainly aware of the risks out there that are causing volatility—specifically, in the case of China and the effect on demand for commodities, China has really been the engine for commodity price increases. If China were to slow significantly, some companies are going to be exposed to downside moves in commodity prices. The steel sector and some of the steel inputs such as iron ore and coal are very large high-yield issuers. We saw spreads widen significantly in August-September of 2011 and since then they have tightened back in, but as Sean says, they remain at what we consider very compensatory levels.

There are other areas of concern, of course; they change over time. We assess them regularly as the macro environment evolves.

Q: How does your approach complement First Eagle Investment Management's value philosophy?

Sean: Like First Eagle, we are very patient value investors. We also look to build our portfolio from the ground up on a fundamental basis, on a credit-by-credit basis, building what we consider to be a margin of safety into our investments. Our margin of safety is a little bit different than on the equity side, but philosophically it's the same concept: We look at the margin of safety as buying a bond at an appropriate place in the capital structure, with an appropriate cushion of leverage to enterprise value. We try to find the attachment point in the capital structure at a level of leverage that gives us a fair amount of equity cushion or subordinated debt cushion below us.

Q: Is there anything about your process that you've changed or you anticipate changing, now that you've joined First Eagle Investment Management?

Ed: What has been great about joining the firm is that on the High Yield team, we are company analysts first; the other investment teams at First Eagle Investment Management are also company analysts first. We focus on debt, the other investment teams focus on equity, but we all fundamentally analyze enterprise value.

We expect we will leverage the company knowledge of other First Eagle Investment Management analysts. We expect the other analysts at First Eagle will leverage our knowledge also. It'll primarily be additive to our process, and a residual of being around other investment professionals.

As it relates to how we manage our portfolio, nothing should change. Our approach has been and will remain focused on building our portfolios from the bottom up and finding opportunities where we feel we're being adequately compensated for the risks.

Q: What is relevant about high yield to equity investors?

Sean: The high-yield market is relevant for equity investors from the perspective that it can give you clues as to how open the credit market is, how much risk investors are willing to take at any given point in time and, essentially, trends within the economy—which sectors are doing well and which are not doing as well.

We think the high-yield market specifically and the fixed-income market generally will lead the equity markets, just on a macro level. For example, in late 2008, the high-yield market began to recover as the primary market opened up and investors began to dip their toe in the water and add risk to their portfolios.¹

The equity market did not begin its recovery until early March of 2009, while the high-yield market was in recovery for probably two and a half months before that. Conversely, back in June of 2007, the high-yield market had reached its tightest level as far as its spreads to Treasuries for the cycle and began to incrementally widen out, beginning in late summer and early fall, which led the equity market by another three to four months. The equity market peaked in October of 2007.¹

High yield can be a leading indicator because in high yield your upside is capped to the coupon that you're receiving and the par level of investment that you're going to receive back, hopefully, at maturity. So high-yield investors are certainly interested in how their companies do quarter by quarter and year by year. Any deviation from expectations will lead to immediate reaction amongst investors as to what risks a company may have.

With equities, on the other hand, since it's a residual claim and since you can hold them much, much longer your upside is theoretically uncapped. So equity investors tend to perhaps be a little bit more patient if a company misses a quarter or two, where many high-yield investors will seek to transition out of companies fairly quickly when they see performance begin to erode.

Q: Are you saying that high yield could potentially be less risky than equities?

Ed: If we speak historically, we should first point out that the high-yield market is only approximately 25 or 30 years old.

Although there have been a similar number of down years in the equities markets and the high yield market, the *intensity* of the decline is what is noticeably dampened in high yield. Let's look at 2008 as the example—the worst-performing year in the past 25. The Barclays Capital U.S. Corporate High Yield Index declined approximately 27%. The MSCI World declined 41%; the S&P 500 declined 37%.¹

A reason for that is the coupon. The coupon may provide a cushion, whereas a stock may not pay any dividend at all.²

Q: Can you describe the high-yield cycle?

Sean: As we said earlier, an important fundamental concept about the high-yield cycle is that at every stage, investors are responding to the historical environment—what has been happening in their recent memory—*not* what is happening in the current environment. As a result, the market generally misprices risk, resulting in spreads that are tighter than they have been historically, despite an environment where leverage is going up and market risks are going up, as well. Conversely, as the market gets defensive, as spreads begin to widen, as the market begins to factor in higher levels of default and economic weakness and other elements of corporate distress, the market will overprice risk or spread levels will be distorted to a degree that may overstate market risks.

¹ Source: FactSet

² Past performance is no guarantee of future results. You cannot invest directly in an index. Performance for other periods may vary.

It's a gradual process as the market misprices risk. It literally takes years, but it's happened time and time again. Since the high yield market has existed, there probably have been four credit cycles. And we believe it'll happen in this credit cycle, as well.

Right now we're still in the early stages of a credit cycle—a relatively benign environment, as far as we're concerned. Companies have been using proceeds from primary issuance to really refinance near-term maturities, which is more creditor-friendly, because it increases the optionality of the enterprise by pushing out near-term maturities to later dates. They've been repairing their balance sheets.

We haven't yet seen much in the way of leveraging transactions, which would be more equity friendly, or primary issuance used for dividends to equity holders, or private equity leveraging up companies to take private, or a sharp rise in M&A activity. As the credit cycle moves forward and as spreads tighten, we would expect more equity-friendly transactions to occur. We're beginning to see more M&A activity.

Q: So what's your strategy for managing through the credit cycle?

Ed: Most importantly, we have to feel that we are being adequately compensated for the risk we're taking. For anything that we buy, we generally expect the credit to stay the same or to improve, and we expect the issuer to be generating a fair level of free cash flow in order to service its debt.

We think of ourselves as risk rotators—we believe that rotating risk in each phase of the high yield market cycle is critical to delivering consistent outperformance. We factor in where we are in the credit cycle and in any phase, we may move to increase or decrease our exposure to higher- and lower-quality credit tiers in order to modify risk exposure in the portfolio. We also adjust the portfolio in terms of where in the capital structure we'll attach, to regulate how defensive we want to be. And we may shorten maturities at times—all with an eye on risk.

We generally have a bias toward a higher-quality portfolio throughout the cycle. So when we do get a little bit more aggressive and reach down the credit spectrum a little bit more than we normally do, we'll tend to increase our exposure to single-Bs versus double-Bs. When we get more defensive we'll begin to gradually reverse that and end up with a portfolio that tends to have an increased exposure to double-Bs and be underexposed to a single-Bs.

Everything that we do, though, is gradual, and it's on a company-by-company fundamental basis. We are typically under-exposed to triple-Cs, because triple-Cs are generally cash-flow consumers—they need the primary market to help them refinance their obligations in order to remain an ongoing entity. We will buy triple-C's, though, that we feel maybe the market is mis-rating.

Q: Can you walk us through your research and filtering process?

Sean: We begin with trying to ascertain where we are in the credit cycle. As we said earlier, we have to feel that we are being adequately compensated for the risk we're taking. When we determine what sectors we want to avoid, it's because of the risks we see embedded in many individual firms within the sector.

Throughout the credit cycle, defaults tend to be clustered in specific sectors. If you can avoid the default clusters and have a little bit more of a defensive portfolio, there is the potential that you will outperform your peers. Once we answer those two questions—

where are we in the cycle, and where are we seeing potential default clusters—then we have a decent idea of how we want to allocate the portfolio.

Then we'll build a portfolio from the bottom up. As we said, we're not sector rotators, we're risk rotators. So, depending upon the amount of risk that we want to take at any given time, we build the portfolio accordingly on a company-by-company basis.

We keep a very close eye on what the market is telling us. As we go forward, we would expect fewer refinancing transactions and more equity-friendly-type transactions and, along with that, credit spreads to continue to tighten. So the market will get riskier, but spreads will be implying that, actually, risks are going down. And then during that process, as the market gradually becomes a little bit riskier, we'll become, very gradually, a little bit more defensive and our portfolio risk will likely move inversely with the risk of the market.

The high-yield market tends to be a very new-issue-driven market, so most things that are added to our portfolio when the market is open are coming from the new-issue market. New issues tend to be priced at a discount to existing paper and so it's an attractive way to get involved in a new name.

There's an active dialogue between the analysts, Ed and me. We are all analysts. For any name to go into the portfolio, both Ed and I have to agree with the analyst covering the name to put the name into the portfolio. We think it's a pretty high hurdle for a name to go in.

Q: What do you focus on in analyzing a company?

Ed: The free cash flow is very important, because that dictates the company's ability to repay debt over time. And, obviously, the overall capital structure, the overall amount of leverage is going to be a key driver as well.

Q: What do you avoid?

Sean: We typically avoid industries with unfavorable dynamics—high exit costs or high regulatory risk. We try to avoid companies with high fixed cost structures, those that are relying upon unrealistic growth to service their debt, and those whose survival depends on the new-issue market remaining open. We also meet with company managements and look at them closely, in an attempt to avoid companies with an indifferent attitude to the interests of creditors or with a proven track record of underperformance.

Q: Do you look for value in the discount that the credit is trading at, or the yields you're getting, or both?

Ed: We look for value in both. At certain points we certainly will buy discounted bonds that we feel have fallen out of favor in the market for whatever reason, and that fundamentally should pull back up to par as company performance improves. Because that spread is just a combination of the coupon and the price. So the lower dollar price increases the overall yield on the security.

We generally look at the spreads and spread per turn of leverage³ that we're getting at any given point in the capital structure. Generally, the higher up in the capital struc-

³ Spread per turn of leverage = The change in yield of the issuer's high yield debt relative to the increase in the ratio of debt to EBITDA

ture you are, the lower the leverage you have. And each point in the capital structure has its given yield.

When we feel we're not getting paid to take incremental risk we will trade up, either to a senior level in the capital structure or to a more defensive sector within the high-yield market and wait until more suitable replacements can be found when spreads are more compensatory.

Part of our past success is that we have a very high degree of discipline in employing this strategy and we pay very close attention to downside protection. We'd rather not invest aggressively in a market when we're not being paid to take risk.

Q: How many names do you end up with in the portfolio, typically?

Sean: At year-end 2011 we had 91 names in the portfolio. As fundamental, bottom-up investors, we only invest when we see what we consider to be the right opportunities. So, the range has been from approximately 90 to 120. It's a fairly concentrated portfolio for high yield. Nonetheless, we don't feel we're too concentrated within the portfolio; maybe some of that is because we are higher in quality (while still in the below-investment-grade category), so that makes us more comfortable with greater concentration.

Q: Do you try to match a benchmark?

Ed: Many investors measure our performance against a benchmark so we're certainly aware of the Barclays Capital U.S. High Yield Corporate Index, but we do not specifically position the portfolio relative to any benchmark. We never have specific sector under- or over-exposure. We're very comfortable having no exposure whatsoever to significant pieces of the benchmark, at times, and then other times we could be double the weight of the benchmark or even more. Again, it's just a matter of how the portfolio develops from the bottom up. This is another synergy between our team's approach and First Eagle Investment Management's investment culture.

While other firms will rotate sectors based on spread, regardless of what the default characteristics may look like, we're focused on rotating risk in order to avoid the weakest sectors, companies and issues. The weakest sectors have competitive dynamics such that if some firms begin to suffer distress and end up filing for bankruptcy, it tends to have a cascading effect on other firms within that sector. Some sectors where we've been careful about our exposure have been autos before the events of 2008, and the tech sector in 2000.

Q: Do you buy just domestic issues or do you go outside the U.S.?

Sean: We've gone outside the U.S. in dollar-denominated or Yankee-type bonds, primarily looking at Western Europe, South America, certainly North America. It's our intention to buy or add, where appropriate, foreign-denominated debt. Historically it has been no higher than a mid-teens percentage of the portfolio, but still could vary.

There is about 15% outside the U.S. currently. We expect that to grow, especially in Western Europe going forward. Currently when you look at most measures of the high-yield market on a global basis, about 85% is domestic U.S.

Q: You've talked about your process, what makes it into the portfolio. Tell us about your sell discipline—what might cause a name to come out of the portfolio?

Ed: As we mentioned, we focus on trying to manage the downside—seeking to avoid the permanent impairment of capital. As a result, there is a fairly high hurdle to get a name into the portfolio, and a fairly low hurdle for a name to get out. For a name to go into the portfolio both Sean and I have to agree, along with the analyst. In contrast, if any one of us has concerns about a name it will leave the portfolio. A holding will also come out if the investment thesis has changed, or if we find better relative value opportunities.

The concerns that will cause us to exit a position can come from a company's operational issues or a drop-off in free cash flow generation. We will also see situations where there's a change in management's attitude towards debt holders or debt. Some companies' managements have been very publicly committed to fulfilling their obligations as debt issuers and we want to be aligned with these management teams. And sometimes that very same management team may turn around and make a leveraging acquisition. This is the sort of thing that concerns us. We take another look at the name to confirm that the basic investment thesis is still intact.

Q: What's been your historical turnover?

Sean: Turnover will vary according to where we are in the credit cycle. So, in the more benign stages of the credit cycle—late recovery, stability—our turnover will be higher. At other times, when we get a little bit more defensive, our turnover will be lower as we hunker down with a defensive portfolio that we're comfortable with holding for quarters, if not years.

Q: Can you tell us about some of your current holdings?

Ed: One of our holdings is Citgo Petroleum. It's the domestic operations for the Venezuelan oil company. This is a true first-lien piece of paper, and they have three good refineries; two in the Gulf Coast and one in the Midwest. They're able to take advantage of buying lower-priced sour crude and refining it into gasoline. The refining differentials are higher for a firm with the more complex refineries like Citgo, versus other firms that refine less sour, more sweet crude. So there's a fair amount of asset coverage. Leverage is reasonable in the 3.5 to 4 times area. They generate a significant amount of free cash and at current yields of right around 8.5%, we feel that it offers significant value versus other energy names.

Also, the ultimate parent of Citgo is PDVSA in Venezuela, but this bond is issued by a U.S. operating company that is a subsidiary of a U.S.-based holding company. So from a structural perspective, we're protected by the laws of the United States and we're insulated, somewhat, from Venezuela, but the market doesn't recognize that and these bonds at 8.5% are probably 150 to 200 basis points wide of where we feel they should trade, if not maybe a bit wider.

Tower Automotive, another portfolio holding, stamps structural components for automobiles. They had to restructure back in 2008, early 2009, and we bought the bonds out of bankruptcy when they re-emerged. Their cost structure is set up to withstand an annual production rate in North America of 9 to 9.5 million vehicles, which was the production rate at the trough of the last credit cycle; they're currently at 13.5 million.

So, we feel that there's a margin of safety from that perspective. They're lightly levered in the 2.5–2.75 range and they generate a fair amount of free cash. We feel that they're levered to an improving economy: There's some protection there if the economy were to weaken a little bit. This holding is yielding around 10%.

Q: What's your outlook for high yield in 2012?

Sean: We feel we're in a favorable spot in the credit cycle. We think that high yield is well positioned, certainly relative to other fixed-income classes such as Treasuries and particularly investment-grade bonds. High yield historically has tended to outperform in an environment with rising interest rates, which we believe will happen at some point in the future.

Relative to other fixed-income classes, high yield has been less impacted by Treasury moves. In general, depending on the level of Treasuries, we would expect high yield to absorb two-thirds or three-quarters of an increase in Treasuries. For instance, if Treasuries move up by 200 basis points, high yield could absorb 100–150 basis points. This is primarily driven by credit quality—the fundamentals of a company—versus the movement of market yields.



Edward Meigs, CFA

Ed is a Portfolio Manager for the First Eagle High Yield strategy with Sean Slein. He joined First Eagle Investment Management, LLC in October 2011.

Prior to joining the firm, Ed was a Portfolio Manager of the Dwight High Yield

strategy at Dwight Asset Management Company LLC, where he focused on high yield opportunities in the gaming/leisure/lodging, home builders and building materials sectors. Previously, he spent four years at Mount Washington Investment Group as a High Yield Portfolio Manager. Prior to that, he served as Vice President at Falcon Asset Management. Ed began his career at Wheat First as a Credit Analyst.

Ed received his B.A. from Occidental College and his MBA from Northwestern University Kellogg School of Management. He holds the Chartered Financial Analyst (CFA) designation.



Sean Slein, CFA

Sean is a Portfolio Manager for the First Eagle High Yield strategy with Ed Meigs. He joined First Eagle Investment Management, LLC in October 2011.

Prior to joining the firm, Sean was a Portfolio Manager of the Dwight High

Yield strategy at Dwight Asset Management Company LLC, where he focused on high yield opportunities in the forest products/packaging, transportation and services sectors. Previously, he spent two years as a fixed income analyst in the private placement department of Allstate Insurance Company. Sean began his career on the floor of the Chicago Mercantile Exchange as an options strategist with Discount Corporation of New York Futures.

Sean received his B.A. from the University of Notre Dame and his MBA from the University of Chicago. He holds the Chartered Financial Analyst (CFA) designation.

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