OSTERWEIS
CAPITAL MANAGEMENT

**All is NOT "Quiet on the Western Front"**
**Fixed Income Outlook**
**October 2017**

When queried about the state of the U.S. stock and bond markets, the casual observer might be tempted to say, "all quiet on the western front." The phrase, taken from the novel of the same name, relates to the perception by others that all was calm in the German soldiers' trenches in World War I, when that was not quite the case. The term has become a metaphor for the appearance of calm and unchanging conditions or circumstances. After watching the S&P 500 Index grind steadily higher to a 4.48% return for the quarter, and seeing the 10-year Treasury bond finish the quarter at a 2.33% yield, only 3 basis points wider than where it started the quarter, it might seem hard to argue with that point of view. Economic releases have continued their slow, irregular growth trend, so not much to add there. However, beyond the seemingly placid markets there is movement beneath the calm that could have future implications for the bond markets, which we feel merits special attention.

The media have enjoyed splattering the papers this year (and last) with negative headlines about the bond market[1, 2], but all their foreboding actually amounts to a mischaracterization of large portions of the fixed income asset class, in particular the market for non-investment-grade bonds, where we have found and continue to find value. While most refer to it as the "high yield" or "junk bond" market, very few people understand that the market is actually an extremely heterogeneous collection of securities whose only real connection is that they are not rated investment grade. Every one of these bonds has a different combination of covenant package, coupon, call schedule, maturity and rating, not to mention the health of the underlying business. It is really a market of individual bonds. As such, it is important to look at each company and security individually and evaluate them on a case-by-case basis against our macro-economic backdrop. An additional way to parse bonds is based upon ownership characteristics of the underlying companies.

We have identified four major subgroups in the market: private family-owned businesses, mid-sized public companies with controlling stakeholders, larger public companies and private financial sponsor-backed companies, usually resulting from a leveraged buyout. Pricing and structures of recent issues in the last two subgroups are where we have identified risks brewing below the surface. Large leveraged buyouts seem to garner the greatest attention from the media, while the larger public company financings generally attract attention from benchmark-oriented investors. Financial sponsors, most notably the large and growing group of private equity companies, have historically used debt to finance significant portions of the purchase prices of their target companies as a way to supercharge the returns of their investment funds. Unlike family-owned businesses that often think in terms of generations, or public companies that have medium- to longer-term goals, financial sponsors tend to have short-term investment horizons. The faster they can recoup their equity investment by paying themselves dividends, the higher the internal rate of return they can post for their funds. That level of self-interest can often be at odds with the interest of bondholders. While the size of initial equity contributions made to acquire companies are close to historic norms, the pace of recoupment of those investments has accelerated, often driven by much higher leverage. This has tilted the risk burden squarely on the bondholders' shoulders. Why haven't bond investors pushed back more forcefully? The answer is nuanced and, without getting too far into the weeds, the devil is in the details. Typically, the most visible elements of a transaction, (the coupon, maturity, seniority and obvious covenants such as call protection) are usually on-market. Hidden deeper in the indenture is where one finds all manner of ways for the sponsor to redirect both cash and collateral away from bondholders. The collateral issue matters greatly if the company hits a rough patch. For instance, in a business that can't meet its financial obligations after being weakened by a siphoning of cash by the equity sponsor, the bondholder may find that there is little or no asset protection, or may end up further subordinated by subsequent issuance of more senior debt allowed by weak protections. As a result, we tend to be very selective when looking at sponsor-driven transactions. There are occasions when the issuers happen to be great companies and have sponsors who are more aligned with longer term growth, but where the pricing or maturity is not to our liking. These are bonds that we place on our watch list. We then actively monitor their trading activity so we can be prepared to buy in the event they cheapen materially in a selloff or become a better strategic fit as their maturities naturally shorten over time.

Moving to the second cohort, larger companies have been issuing "benchmark" debt with ever lower coupons as this cycle has matured. These securities are typically bought by funds, such as exchange-traded funds (ETFs) and more index-oriented buyers without much care as to covenants or the absolute return characteristics of the bonds themselves or the health of the underlying business. Since these funds are measured purely on their relative performance to a high yield benchmark, they are somewhat indifferent to the level of coupon paid or any quirky covenants (or lack thereof). If the bond will be included in their benchmark index, these investors will typically buy. This group of bonds has seen the most yield compression, and we feel that in a meaningful correction, because of the low nominal coupons and lack of downside protection (read: no yield support), some will represent a fertile source of future opportunity for us to add high quality companies to our roster. Additionally, by staying on the sidelines in this sector, we are not foregoing above-market yields and are potentially guarding principal.

On the positive side of the ledger, we are particularly encouraged by the significant uptick in new convertible debt issuance so far this year. Underwriting volumes are running roughly 35% ahead of 2016 levels but, more importantly, the composition of the issuers is changing in a positive direction. Over the last several years, the preponderance of issuance has come from the biotech industry, the energy sector or from Business Development Companies and Master Limited Partnerships, whose underlying shares were yielding substantially more than their convertible bonds. These are sectors of the convertible market that we have typically avoided due to the unattractive fundamentals of such companies and the poor risk/reward characteristics of the securities they have issued. Excitingly, this year we are seeing a more diverse collection of higher-quality companies issuing bonds in the convertible market. We have added to our convertible position when opportunities presented themselves and hope to increase our exposure further if prices correct to even more attractive levels.

Looking ahead, we feel that given the absolute level of asset pricing, the change in direction at the Federal Reserve towards interest rate normalization and the volatility of the geopolitical climate together paint an uncertain picture that warrants a continued defensive posture. We continue to favor investments in shorter duration high yield bonds and some convertibles while maintaining a comfortable cash position to enable us to move quickly to take advantage of corrections, should they occur.

As always, we thank you for your continued support and welcome your comments and questions.

Sincerely,

Carl Kaufman Bradley Kane Craig Manchuck

[1] "The Bond Market is Shifting so Steady Yourself" 1/13/17, New York Times.
[2] "A Caution Light for High Yield Bonds" 3/2/17, Investment News.

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*It is not possible to invest directly in an index.*

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*The S&P 500 Index is an unmanaged index that is widely regarded as the standard for measuring large-cap U.S. stock market performance.*

*A yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality but differing maturity dates.*

*A basis point is a unit that is equal to 1/100th of 1%.*

*Coupon is the annual interest rate paid on a bond, expressed as a percentage of the face value.*

*Duration measures the sensitivity of a fixed income security's price (or the aggregate market value of a portfolio of fixed income securities) to changes in interest rates. Fixed income securities with longer durations generally have more volatile prices than those of comparable quality with shorter durations.*
*[28927]*