Strategic Income Management

*Value Driven, Income Focused*

# High Yield Strategy

January 2024

# Table of Contents

Section One:

# Organizational Overview

# History of Team

- Strategic Income Management was incorporated August 2010 in Seattle, WA.
- **Same strategy for 24 years** managing high yield portfolios.
- Public track record from 1998-2009 at Principal** and under current fund with American Beacon* from 2011-present achieving top decile performance for both across 3-, 5-, and 10-year periods, as ranked by Morningstar.
- Institutionalized Philosophy & Strategy by fostering talent and leadership from within
  - Co-Lead Portfolio Manager Ryan Larson (13 years under SiM strategy)
  - Investment Analyst Kevin Power (8 years under SiM strategy)
- 100% employee-owned boutique firm specializing in High Yield with a compensation structure aligned with Client Success (Performance bonuses and firm income)

**Data provided by Morningstar. SHOIX (institutional class) **CPHYX (load waived) 5-star ranking from 11/05 to 5/09. CPHYX 4- or 5-star rating from 4/03 to 5/09. Past performance is no guarantee of future results.*

# Firm & Product Overview

- **Total firm AUM:** ~$2.1 Billion
  - AB Mutual Fund AUM: ~$1.3 Billion
  - Separately Managed Accounts AUM: ~$500mm
  - UCITs AUM: ~$300mm

- Client types: Public Pension Funds, Insurance Companies, sub-advisor for US '40 Act registered Mutual Fund and UCITs Fund

Section Two

# Investment Philosophy

# What makes SiM US High Yield unique?

A distinctive approach to High Yield investing

## Typical US High Yield Manager:

- Closet indexers + or minus 1-2% of an industry
- 250+ Issuers/Names
- Diluted by Large Teams
- Match index performance as a goal

## The SiM Approach:

- Differentiated
- Unique Strategy
  - Core – Appropriate Companies for HY
  - Out-of-Favor – Exploit Greed and Fear
  - Small Cap – Extra 100 bps Coupon
- Index Agnostic
- High Conviction ~80 Issuers/Names
- Portfolio Managers are Analysts first
- Differentiation has allowed SiM to consistently outperform

# Strategic Income Management (SiM)

Portfolio

## 3 x 3

**Core**

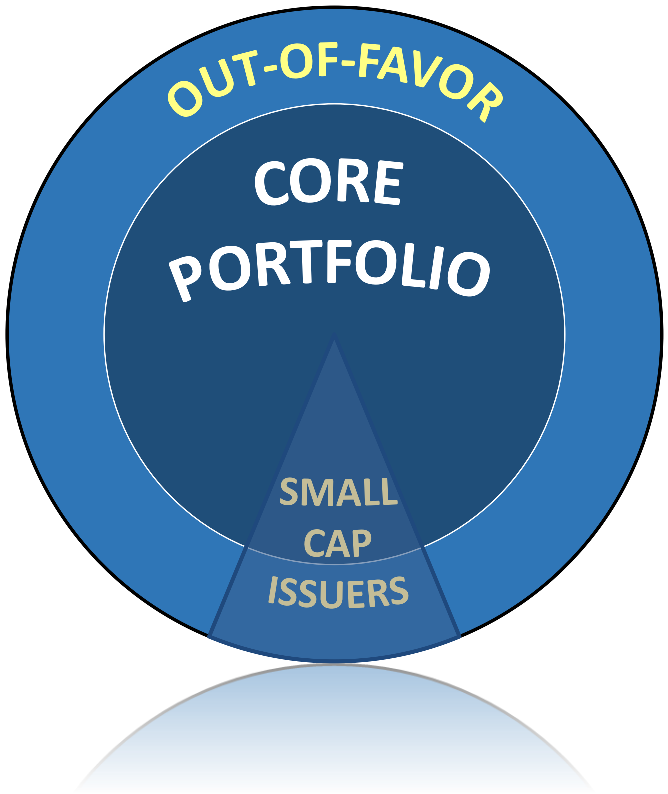
- Long-term secular trends
- Suitable Industries
- Good Businesses

**Out of Favor**

- Viable Industry
- Catalyst for Change
- Long Runway

**Small Cap**

- Yield Advantage
- Rating Agency
- Neglected by larger peers



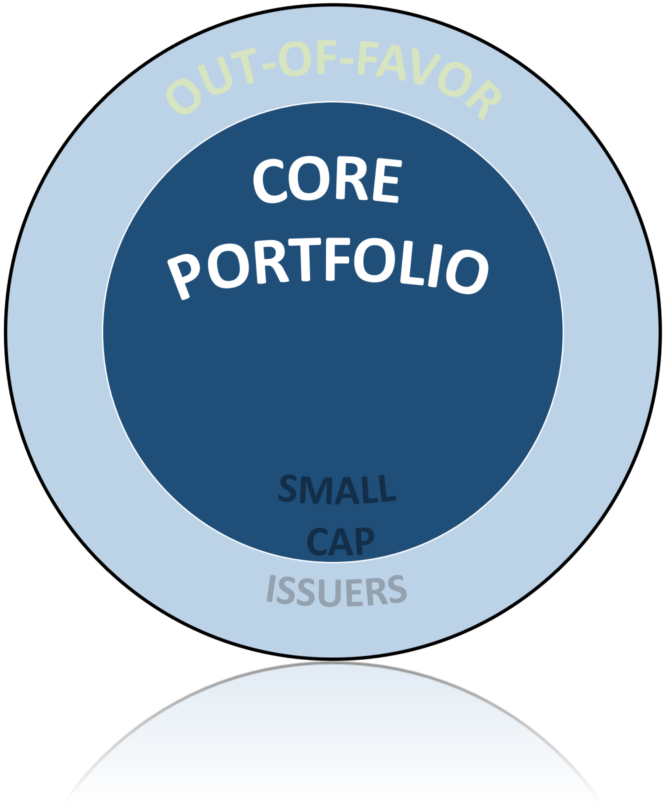
# The Core Portfolio

Building Our High Yield Portfolio

Our three principles - Identifying long-term trends, focusing on the ”right industry,” and performing a “CFO-level analysis” – are applied to create the ***Core*** of the portfolio.

**The Core results in a portfolio that:**

- Tends to be less cyclical
- Provides better downside protection
- Provides more alpha over the long run



# Out-of-Favor Sectors

Supplementing the core of the portfolio

## Same Principles applied to Core are applied in Out-of-Favor Sectors:

- Invest in sectors supported by long term trends.

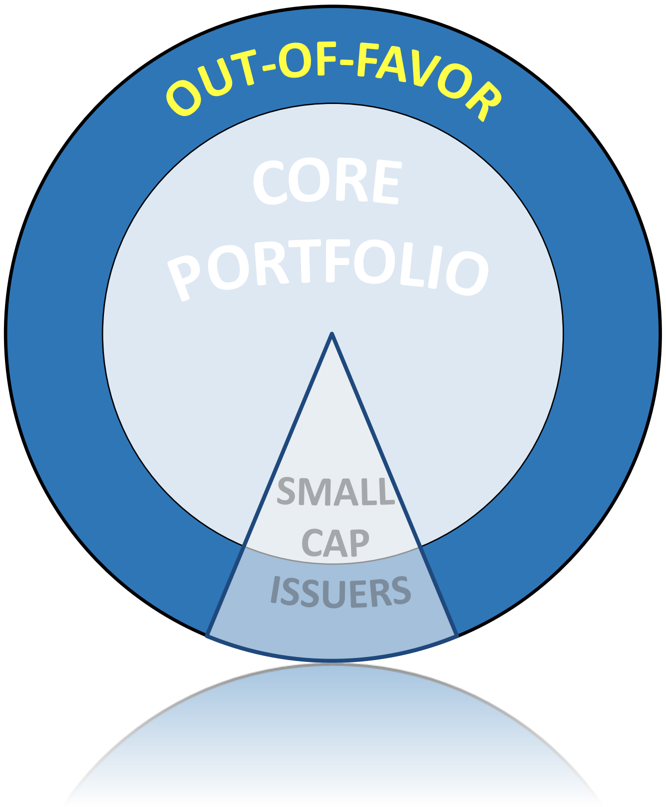
  Invests in out-of-favor sectors that have long-term viability and only suffer from temporary dislocations.

- Invest in the right industries.

  There should be a clear pathway to a rebalancing of the industry, usually through a removal of excess supply.

- Analyze as a CFO to ascertain that the company can endure.

  Rebalancing of industry can take years. Company should have the cashflow, balance sheet, product and management to endure.



# Out-of-Favor Sectors

Supplementing the core of the portfolio

## Market continually offers Out-of-Favor opportunities

Through multiple business cycles SiM repeatedly exploits Out-of-Favor opportunities.

| | |
|---|---|
| 1998 | Asian Crisis |
| 2000 | Tech Bubble |
| 2002 | Telecom Bubble |
| 2004 | Healthcare |
| 2008 | Auto |
| 2008 | Financial Crisis |
| 2011 | European Financial Crisis |
| 2012 | Airlines |
| 2013 | Farm Economy |
| 2015 | Oil collapse |
| 2018 | Shipping |
| 2020 | Leisure |
| 2023 | Real Estate |

SiM often has little or no exposure to some of the more cyclical sectors, but when they fall deeply out-of-favor SiM may take an overweight position.

Once a sector recovers, SiM may exit and not return for years. *(One argument against a pool of specialized analysts.)*

# Investing in Small Cap Issuers (total bonds outstanding <$500 million)

Rounding out the portfolio

## Advantages of Investing in Small Cap Issuers

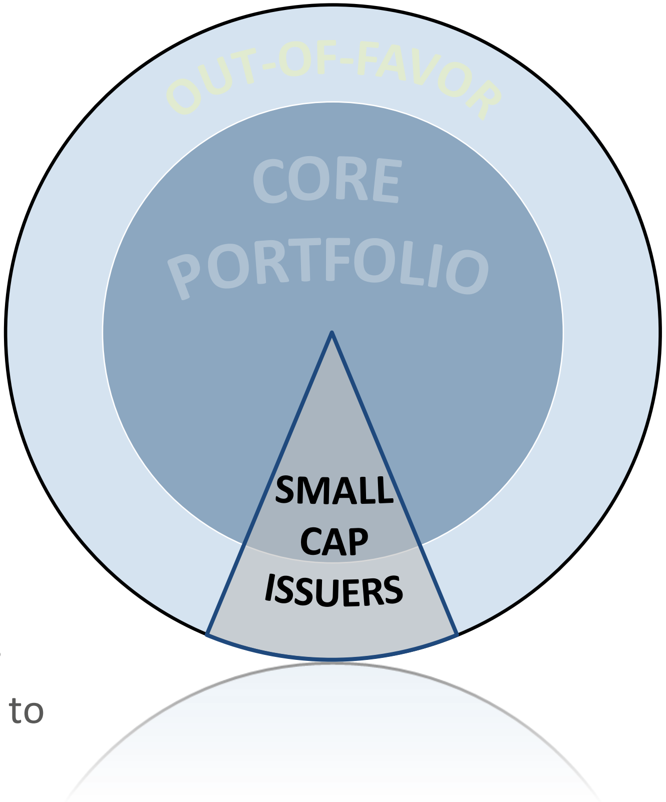
- Small Cap single-B issuers in the index offer higher OAS than Large Caps with same rating.

## Nature of Small Cap

- Comprise more than third of issuers in the Index.
- Large AUM investors ignore–cannot take position large enough to make a significant contribution.
- Rating agencies penalize companies just for being small.

## Liquidity

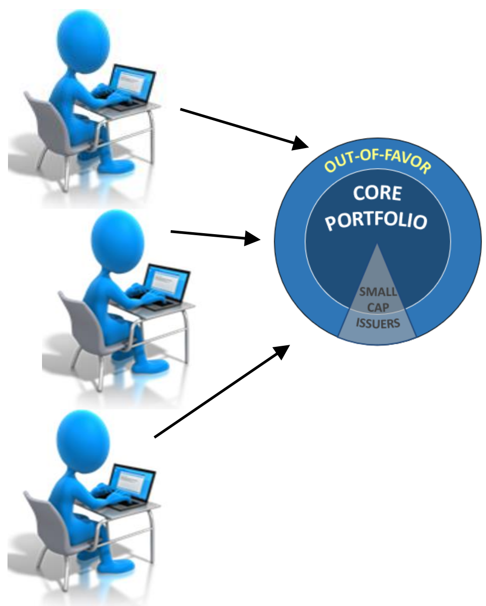
- 96% of SiM Small Cap classified as moderate to highly liquid by a third party. Liquidate position in <7 days.
- 70% of SiM Small Cap has publicly traded equity.
- Team has managed liquidity with small cap for 21 years.
- More focused portfolio of 80+ issuers enables SiM trader to be more in touch with buyers/sellers than large funds juggling hundreds of names.



# SiM's Unique Process

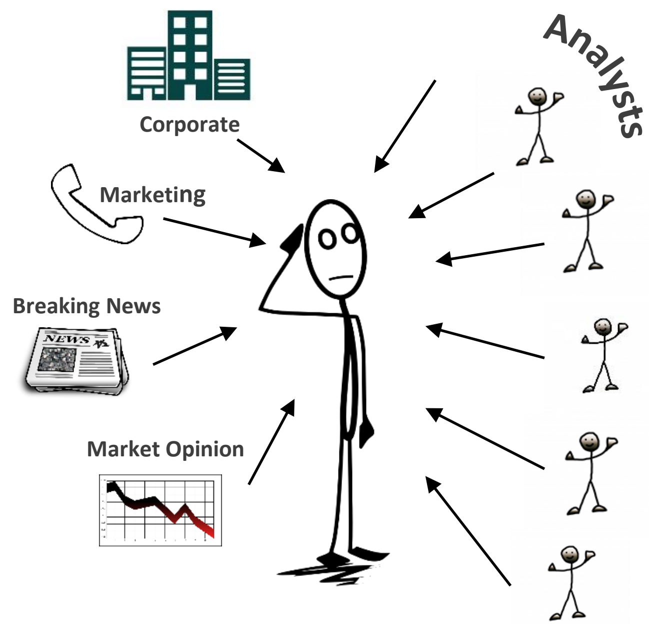
A distinctive approach to High Yield investing

SiM




VS.

**Competition**




- All Day Analysis and Portfolio Management
- What does my calendar look like today?

**Resulting Portfolios**

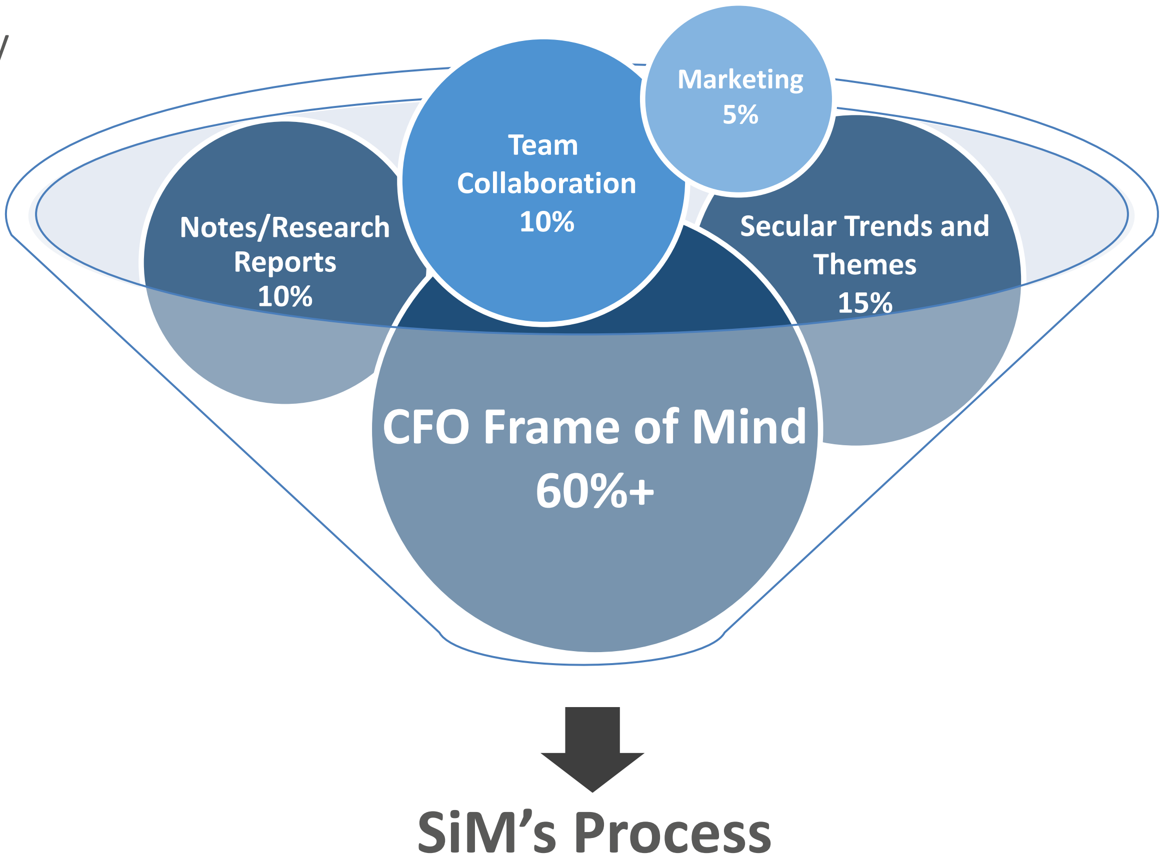
| SiM | Competition |
|---|---|
| • Defined Strategy | • Index Following |
| • High Conviction | • Broad Market Calls |
| • 80 Holdings | • 250+ Holdings |

# SiM's Unique Process

A distinctive approach to High Yield investing

- Process is a product of SiM strategy
  - ✓ Secular themes
  - ✓ Industry first
  - ✓ CFO Frame of Mind
- Small team allows for
  - ✓ Effective communication
  - ✓ No jockeying
- Corporate partnerships allow the SiM team to focus on Research not Marketing

**How SiM team spends their time**



# SiM's Unique Process

A distinctive approach to High Yield investing

**High Yield Universe**

2000+ issuers
100+ Unique Industries

Identify long term trends and themes

Focus on Core Industries ideally suited for HY Bonds

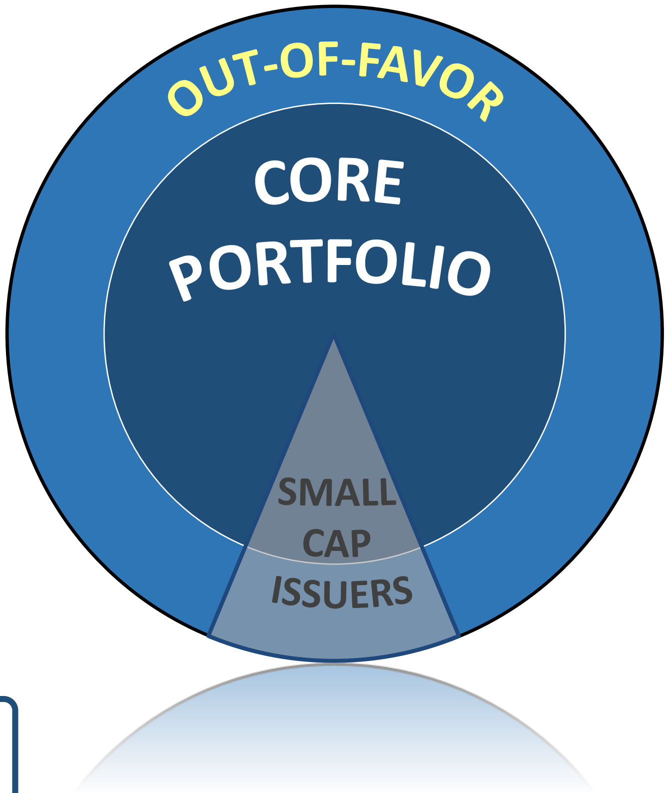
Evaluate Out of Favor Industries and Asset Classes

500 issuers
30-40 Unique Industries

**SiM Portfolio**

80-100 issuers
30-40 Unique Industries

## The Portfolio



# Position Sizing

- Initial positions will vary in size between 0.5% and 2.25% based on risk return profile and liquidity of issue
- Positions are typically trimmed if they grow to >2.75%
- No more than ~10% in any given issuer
- Rarely more than 20% exposure to any industry (especially Out of Favor)
- We target cash to be 0.5%-1% of the portfolio. We maintain a cash position strictly for liquidity purposes
- Country allocation is predominately US and Canada with any FX exposure hedge back to the USD

# Sell Discipline

- 5 circumstances that will cause us to sell a position
  - Position gets too large (>2.75% of portfolio).
  - Selling a core position to fund the purchase of an out of favor position.
  - Selling a position when it becomes too rich.
  - Selling a position when results differ materially from management guidance and our expectations (~2 quarters).
  - Our rational is challenged by changing Industry dynamic.
- Historical Portfolio Turnover 30%-50% (Currently ~50%)

# Risk Management Philosophy/Process

- **Qualitative**
  - Non-cyclical/counter-cyclical Core
  - Low CAPEX/Predictable cashflow
  - SiM doesn’t reach (best of breed businesses)
  - PM’s are Analysts first
- **Quantitative**
  - Core vs. Out of Favor
  - Ex-Post & Ex-Anti Beta
  - Standard Deviation, Tracking Error, Correlation
  - Scenario Analysis (Bloomberg Port)
  - Stress test Individual Issuers (Out of Favor)

# Liquidity

- ~95% of SiM holdings are classified as moderate to highly liquid by a third party. Liquidate position in <7 days
- ~90% of SiM holdings are Public Companies vs. ~80% for Index
- No more than ~10% of any given issue to reduce liquidity risk
- Team has managed liquidity for 23 years through multiple cycles and various large redemptions without a problem
- More focused portfolio of ~80 issuers enables SiM trader to be more in touch with buyers/sellers than large funds juggling hundreds of names

Section Three:

# Portfolio Characteristics

## SiM Portfolio Characteristics

12/31/2023

| Characteristics Summary | SiM | HY Index* |
|---|---|---|
| Price | 93.2 | 94.3 |
| Yield To Worst | 8.0% | 7.6% |
| Option Adjusted Spread | 389 | 344 |
| Coupon | 6.0% | 6.1% |
| Rating | B+ | B+ |
| Current Yield | 6.3% | 6.5% |
| Yield To Maturity | 8.1% | 7.9% |
| Effective Duration | 3.1 | 3.1 |

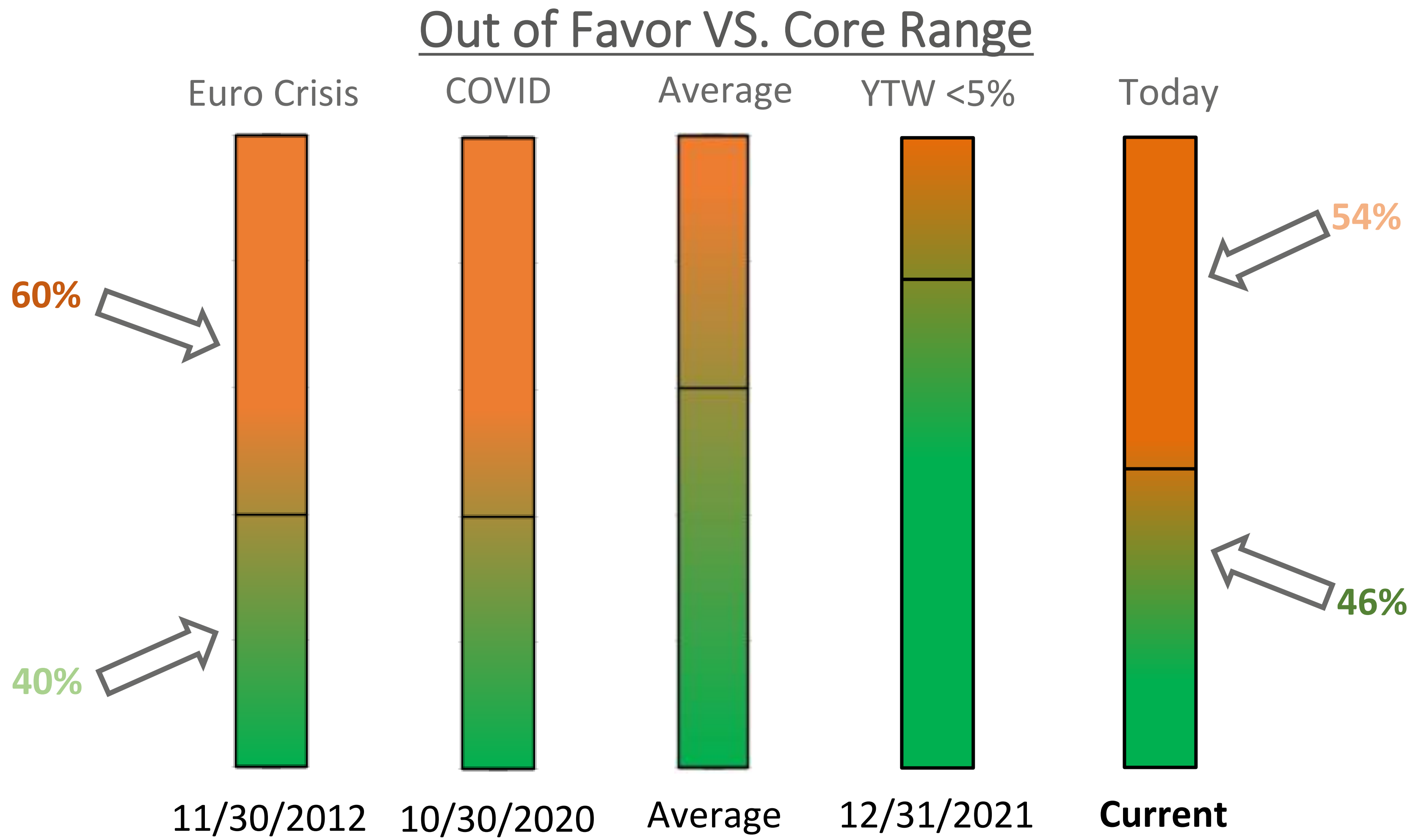
**CORE: 46%**

**Out Of Favor: 54%**
**Deep Out Of Favor: 17%**

**ICE BAML HY Index*

# Strategic Income Management (SiM)

Value Driven, Income Focused



# Changes during COVID-19

## Additions

- Leisure/Consumer Discretionary +6.75%
    - Theme Parks (1%)
    - Restaurants (0.5%)
    - Auto Retail (1.25%)
    - Online Retail (1%)
    - Theaters (1.5%)
    - Vacation Time Share (1%)
    - Airline Supplier (0.5%)
- Busted Convertibles +5.5%
    - Technology (1.75%)
    - Consumer Discretionary (3%)
    - Other (0.75%)
- Energy +8.5%
    - High Quality BB-Rated E&P (8.5%)

## Sample Companies

Winnebago
Marriot Vacations
Square
Six Flags
Boyd Gaming
Chefs' Warehouse
Etsy
Cinemark
Brinker (Chili's)
QVC
Cenovus Energy
Canadian Natural Resources
Penske Auto Group

# Recent Additions to Out of Favor

- Portfolio has held up extremely well due to the high Core position entering the year
- Increased Out of Favor from 19% to 54%
- Added high quality energy names
- Added high quality (IG rated) European REITs & some other quality companies
- Market pullback has been orderly thus far so no industry specifically Out of Favor

## Sample Company additions

Meg Energy
Encore Capital
PRA Group
AMG Capital
Turning Point Brands
Vector Group LTD
QVC Inc
Victoria's Secret
Pharming NV
EZ Corp
Crestwood Midstream Partners
Calumet Specialty Products
Heimstaden Bostad
British Airlines
Anywhere Now (Realogy/Sotheby's)

The specific investments identified and described are not representative of all of the investments purchased, sold, or recommended for the strategy. It should not be assumed that any investment identified has or will be profitable. There can be no guarantee that similar investment opportunities will be available in the future or that SiM will be able to exploit similar investment opportunities should they arise.

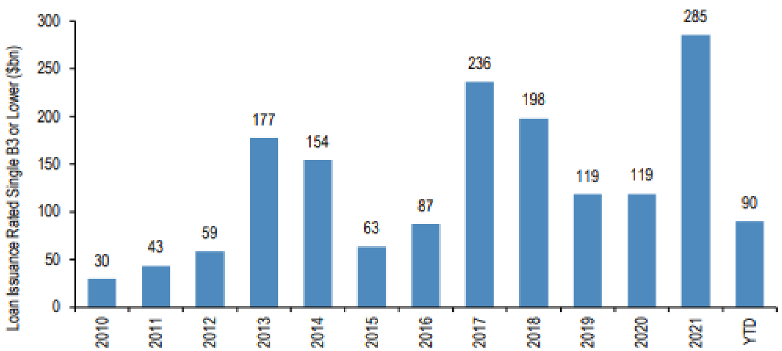
Section Four:

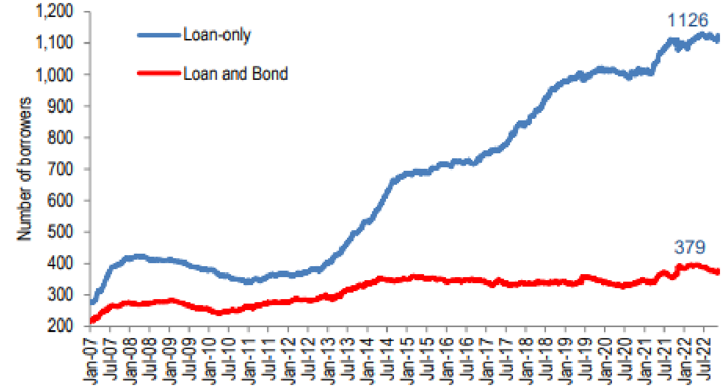
# High Yield Market Characteristics

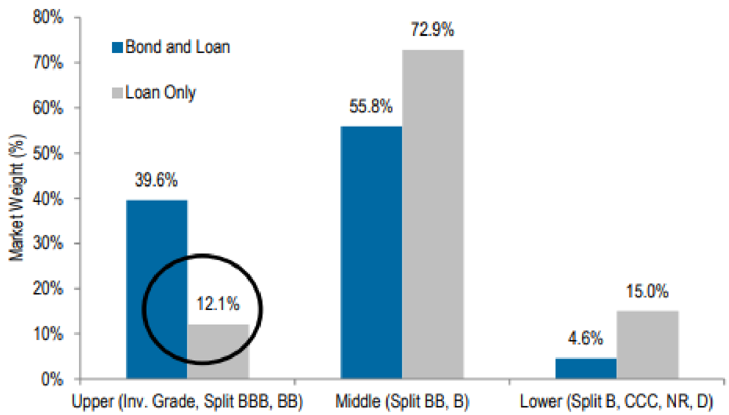
# Strategic Income Management (SiM)

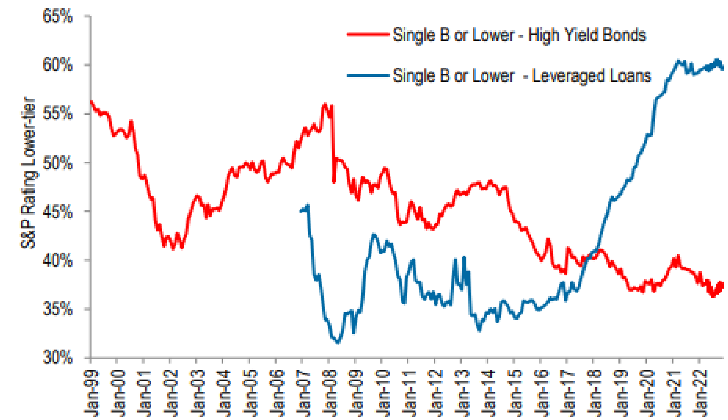
HY Cleansed – Less Risk

## Strength of loan capital markets absorbs HY risk




Source: J.P. Morgan

## Why Structural Position in High Yield?

- Ideal Diversifier with low correlations to other asset classes
- High Sharpe Ratio with high absolute returns comparable to equity
- Historically short periods to recovery from drawdowns
- Down years historically been both rare and shallow

Within High Yield the US should structurally be the majority of exposure

- US is the deepest, most mature market with the broadest diversity in industry exposure and geographic exposure.

# Strategic Income Management (SiM)

What Companies are classified as High Yield

## Rising Stars

~20% of HY Market

Examples:

- Netflix
- Tesla
- T-Mobile
- Toll Brothers
- Alcoa
- HCA Healthcare
- JBS
- Dell
- Centene Corporation

## Long-term HY

~60% of HY Market

Examples:

- Post
- Goodyear
- MGM Grand
- Albertsons
- Hilton
- ADT
- Univision
- Caesars Entertainment

## Fallen Angels

~20% of HY Market

Examples:

- KraftHeinz
- Carnival
- Ford
- ally
- Delta
- Nordstrom
- OXY Occidental
- American Airlines
- Royal Caribbean International
- Anadarko Petroleum Corporation
- macy's

## High-Yield has Fewer Drawdowns Vs. Equity

### Drawdowns over past 40 years

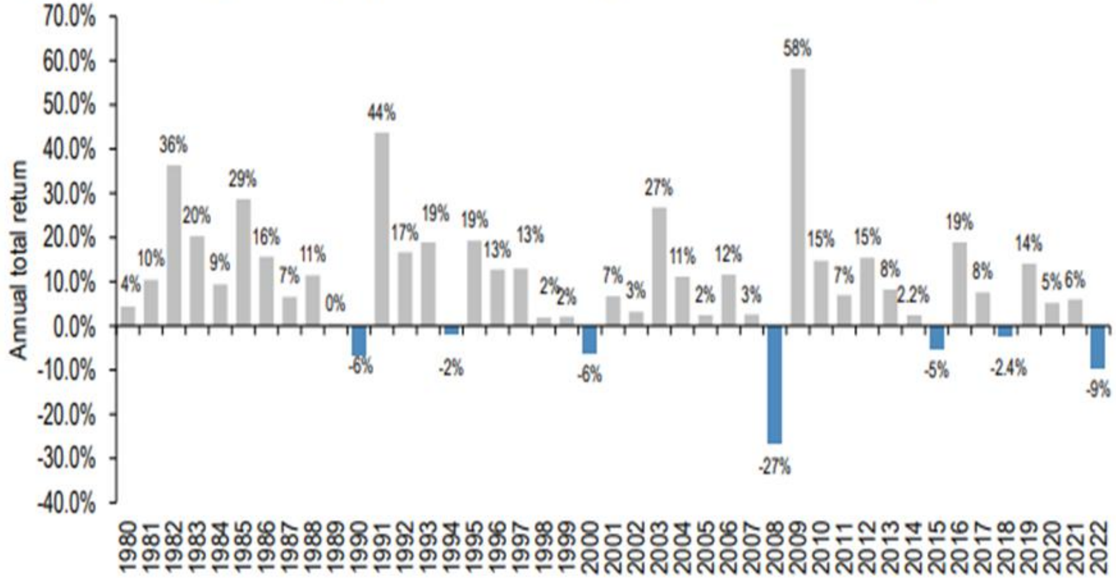
*S&P 500*

- 9 down years
- 4 years 10% or greater loss
- Tech Bubble ~6yrs to recover
- GFC ~4.5yrs to recover

*High Yield Bonds*

- 6 down years
- 1 year 10% or greater loss
- Tech Bubble ~2yrs to recover
- GFC ~2yrs to recover

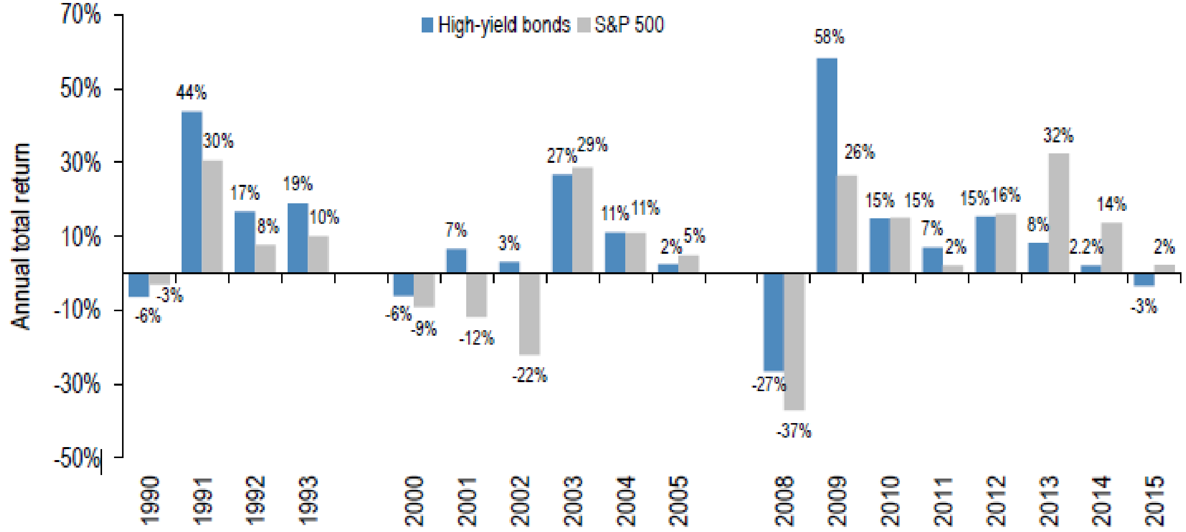
Figure 14: Including 2022, high-yield bonds have only posted seven losses in 40yrs




Source: J.P. Morgan.

# High-Yield has Recovered Quicker vs. Equities

Figure 11: High-yield bond versus equity performance during and emerging from recessions




Source: J.P. Morgan.

- High-Yield bonds have outperformed equities during down years, while exhibiting equal or greater performance in the years leading out of a recession.

# High-Yield is an Ideal Diversifier

## Risk and returns of various assets

### Twenty five-year correlation ended November 30, 2022

| | 5-year Treasury | 10-year Treasury | LB Aggregate Bond Index | Investment-grade bonds | High-yield bonds | S&P 500 | Wilshire 5000 | Russell 2000 | Gold | US Inflation |
|---|---|---|---|---|---|---|---|---|---|---|
| 10-year Treasury | 0.93 | | | | | | | | | |
| LB Aggregate Bond Index | 0.83 | 0.87 | | | | | | | | |
| Investment-grade bonds | 0.56 | 0.63 | 0.87 | | | | | | | |
| **High-yield bonds** | **-0.17** | **-0.15** | **0.23** | **0.54** | | | | | | |
| S&P 500 | -0.26 | -0.23 | 0.04 | 0.29 | **0.67** | | | | | |
| Wilshire 5000 | -0.26 | -0.24 | 0.05 | 0.29 | **0.69** | 0.99 | | | | |
| Russell 2000 | -0.29 | -0.28 | -0.01 | 0.24 | **0.68** | 0.84 | 0.89 | | | |
| Gold | 0.29 | 0.28 | 0.32 | 0.31 | **0.14** | 0.05 | 0.07 | 0.07 | | |
| US Inflation | -0.24 | -0.26 | -0.24 | -0.21 | **0.07** | 0.02 | 0.02 | 0.02 | 0.03 | |
| **Leveraged loans** | **-0.33** | **-0.33** | **0.03** | **0.33** | **0.82** | **0.51** | **0.52** | **0.53** | **0.03** | **0.21** |

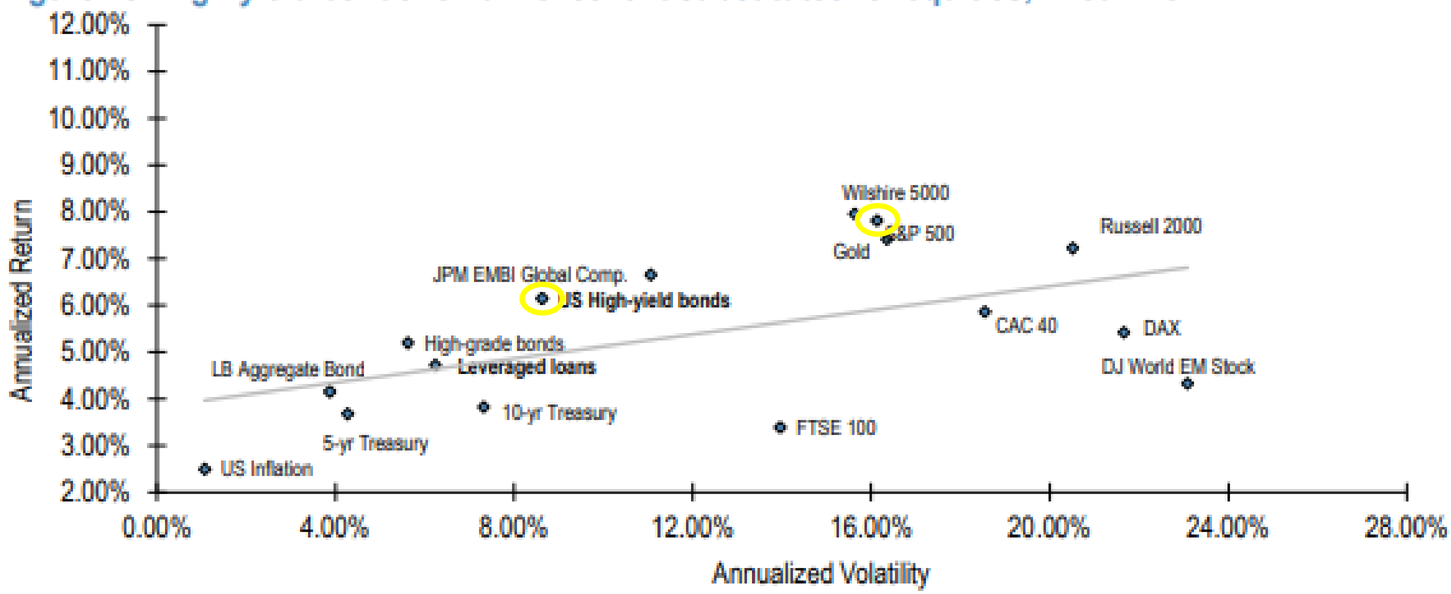
Sources: J.P. Morgan; Bloomberg Finance L.P.

- Historically lower correlations during market downturns

## High-Yield remains excellent substitute for equity

*(Statistics over past 25 years as of November 2022)*

**Figure 15: High-yield bonds remain excellent substitutes for equities, in our view**



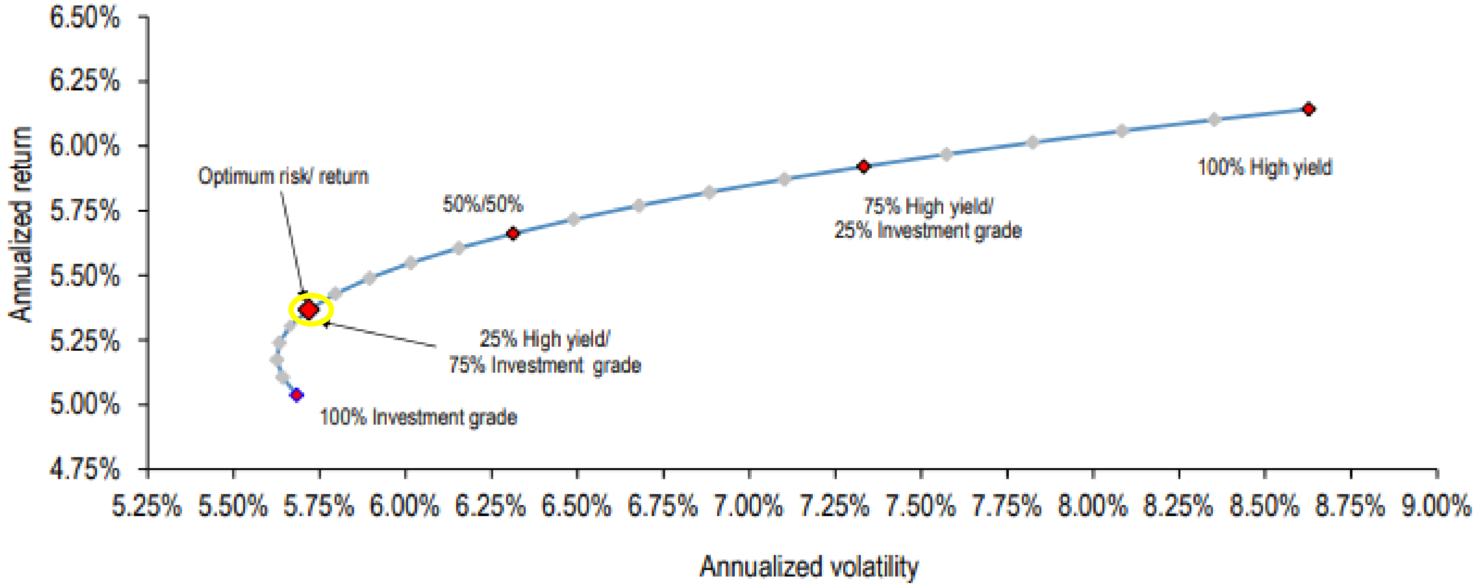

Source: J.P. Morgan.

## High-Yield bonds diversification in action

*(Statistics over past 25 years as of November 2022)*

**Figure 16: Risk/return trade-off**

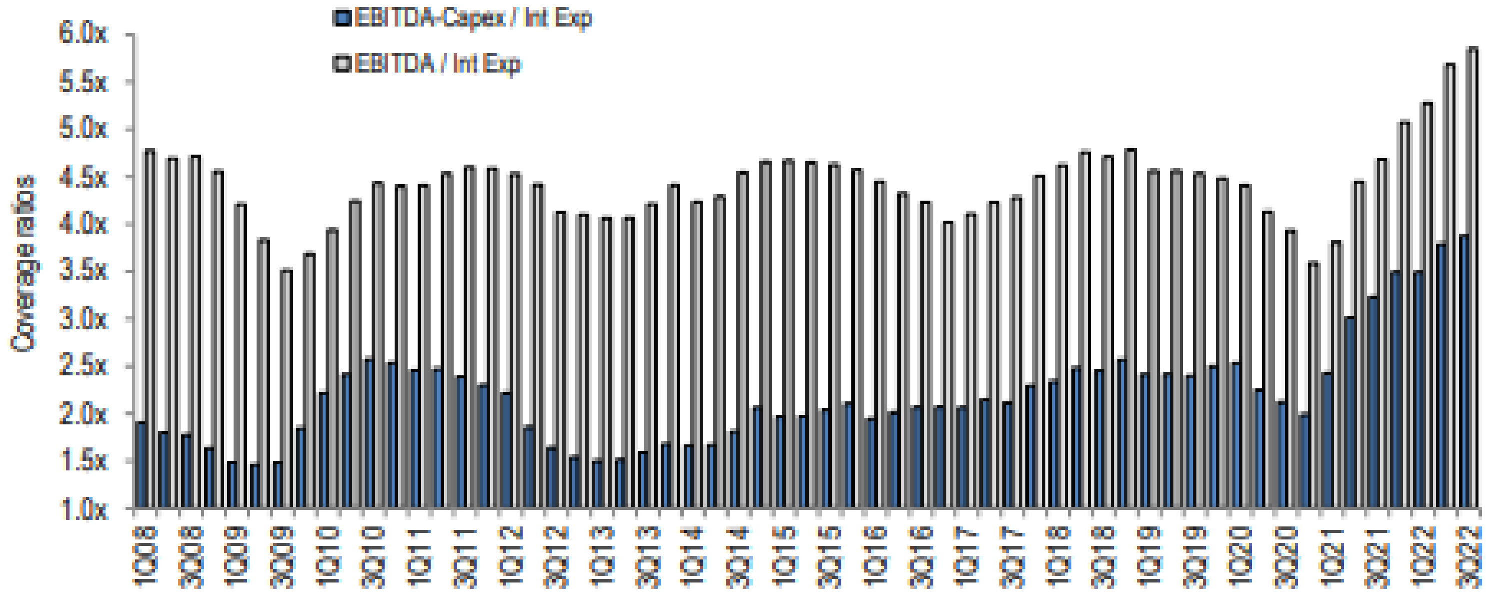
(investment-grade vs high-yield bonds: 25 years ended November 30th, 2022)




Source: J.P. Morgan.

## High-Yield Bonds are very strong structural

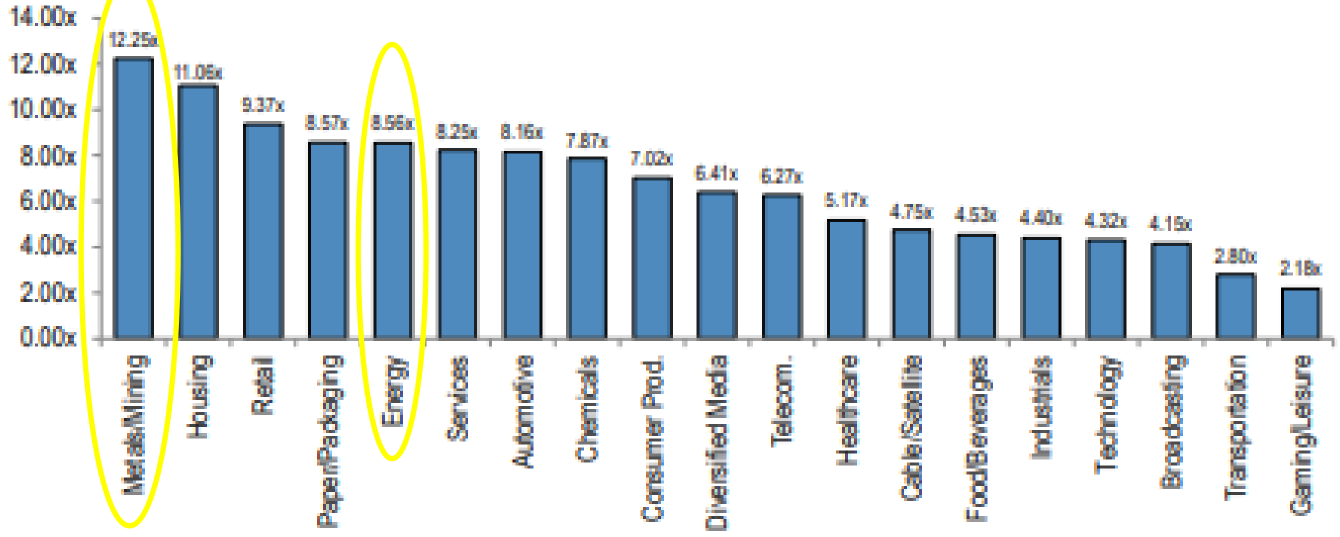
Figure 10: Coverage ratio increased to a record high in a fourth consecutive quarter




Sources: J.P. Morgan; Capital IQ.

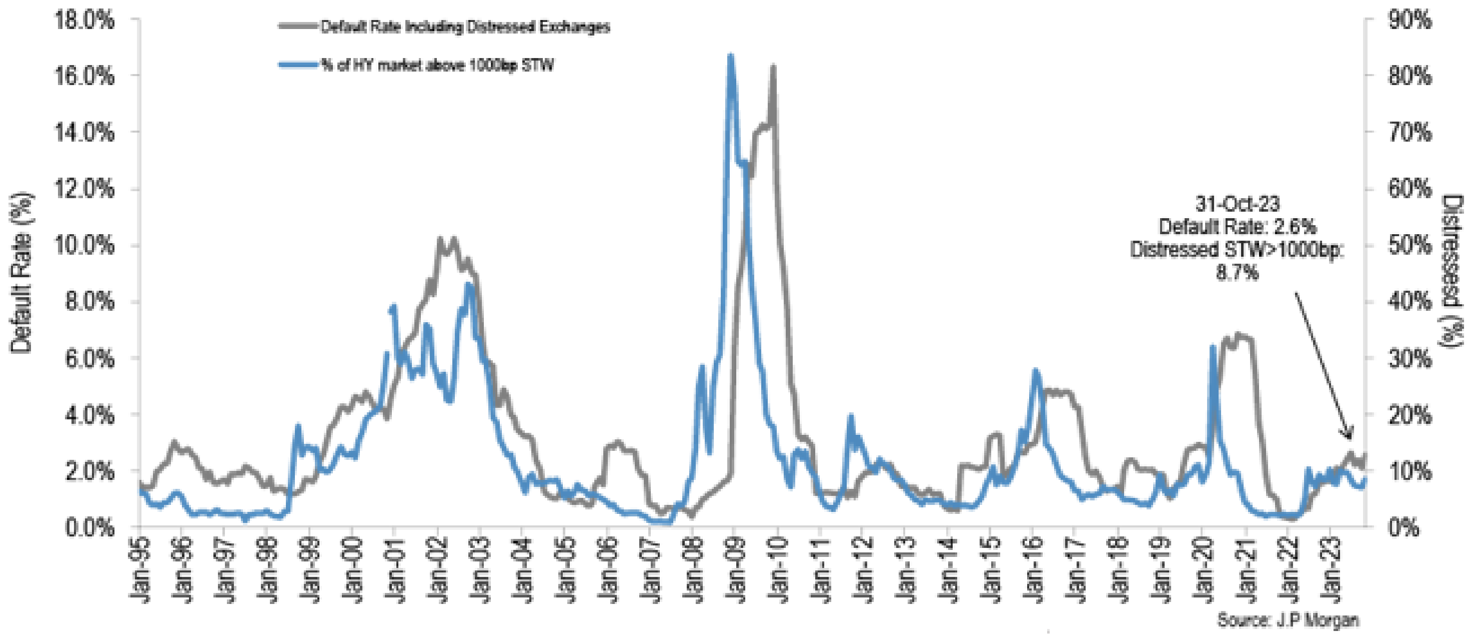
# High-Yield Bonds are very strong structural

Figure 12: Coverage by industry




Sources: J.P. Morgan; Capital IQ.

## High-Yield Bonds Historical Defaults & Recoveries



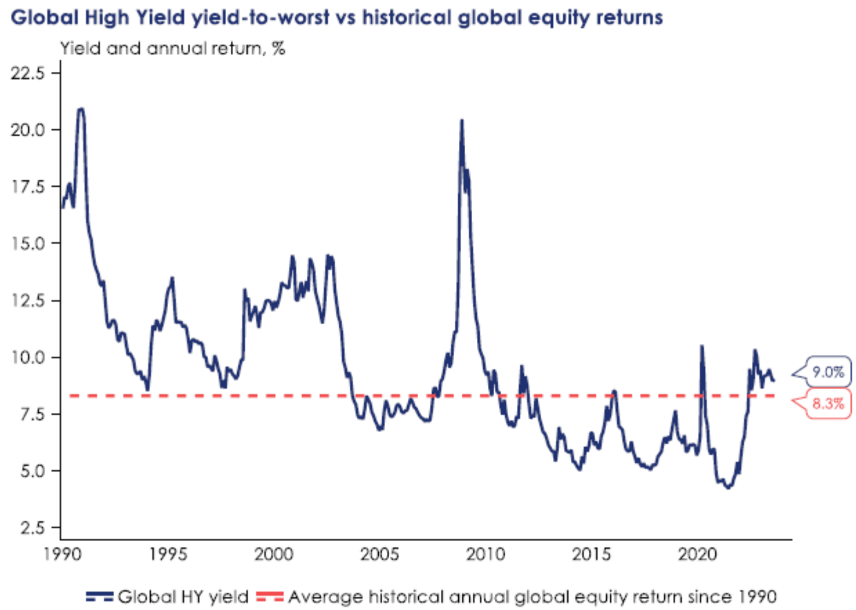

JPM forecasts HY default rates of 3.0% (2023) & 3.25% (2024) vs 3.5% (2023) & 4.0% (2024) for leveraged loans.

Default Rates have averaged ~3.2% annually over the last 25 years

Recovery for HY bonds has averaged ~40% over the last 25 years

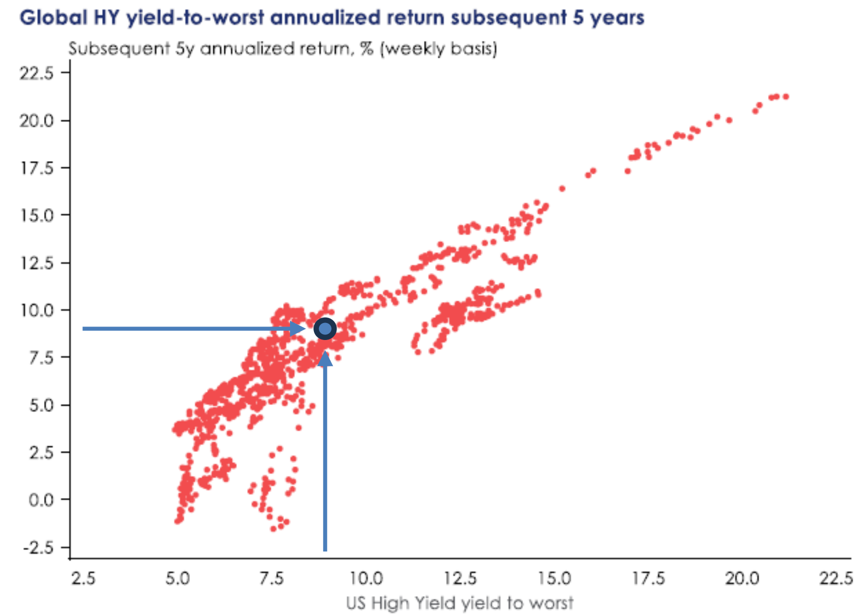
# Historical Yield to Worst vs. HY subsequent annualized returns

### Global High Yield yield-to-worst vs average global equity 1990-




Sources: Clarksons Securities AS, Macrobond, Bloomberg

### Correlation between yield to worst and annual returns next 5yrs.




Sources: Clarksons Securities AS, Macrobond, Bloomberg

# High Yield Forward Return After Fed Pauses Rate Hikes

High Yield Forward Performance Post a Pause in Fed Policy Hikes

| Month of last hike | Fed Funds Terminal Rate | HY Spreads at end of hiking cycle | HY Forward Returns 12 mo. | HY Forward Spread Change 12 mo. |
|---|---|---|---|---|
| Dec-18 | 2.50% | 567bp | 14.08% | -143bp |
| Jun-06 | 5.25% | 359bp | 11.83% | -35bp |
| May-00 | 6.50% | 661bp | 3.33% | 81bp |
| Mar-97 | 5.50% | 325bp | 15.72% | -7bp |
| Feb-95 | 6.00% | 437bp | 16.51% | -28bp |
| | | | | |
| **Average** | | **470bp** | **12.30%** | **-26bp** |

Source: J.P.Morgan

Spreads have exceeded 700 bps only 8% of the time over the last 10 years

On average, spreads have tightened post a pause in Fed policy hikes

# Biographies

**Gary J. Pokrzywinski, CFA**

Mr. Pokrzywinski is Co-Lead Portfolio Manager for the SiM High Yield Team. He has 30+ years of investment experience and shares portfolio management responsibilities with Ryan Larson. Prior to founding SiM in August of 2010, Gary acted as CIO and Portfolio Manager on a number of fixed income portfolios, including a dedicated high yield mutual fund, for Edge Asset Management, an affiliate of Principal Financial Group. He worked for Edge and its predecessor from 1992 to 2009. During his tenure at Edge Gary managed the Morningstar 5-star** Principal High Yield mutual fund from its inception in April 1998 to his departure in May of 2009. He received a bachelor's degree in finance and management information systems from the University of Wisconsin - Milwaukee. Mr. Pokrzywinski earned the right to use the Chartered Financial Analyst designation in 1989 and is a member of the CFA Society of Seattle.

**Ryan C. Larson, CFA, CAIA**

Mr. Larson is Co-Lead Portfolio Manager for the SiM High Yield Team. Mr. Larson shares responsibilities for portfolio management with Gary Pokrzywinski and leads investment research and analytics at SiM. Ryan has 15 years of Investment experience and has been with SiM since the founding of the firm in August of 2010. Mr. Larson earned the right to use the Chartered Financial Analyst designation in 2012 and is a member of the CFA Society of Seattle. Mr. Larson also earned the right to use the Chartered Alternative Investment Analyst Association (CAIA) designation in 2012. Mr. Larson graduated with honors in Commerce, Organization and Entrepreneurship from Brown University in 2008.

**Kevin Power, CFA**

Mr. Power is a high yield analyst and trader for SiM. Prior to joining SiM in 2016, Mr. Power worked as a business loan officer at Business Impact NW, a non-profit Community Development Financial Institution, where he underwrote and serviced business loans. Prior to Business Impact NW, from 2006-2015, Mr. Power worked at Bank of America, in various roles, but most recently as a Banking Center Manager. Mr. Power holds a B.S. in Economics from the University of Washington.

**CPHYX (load waived) 5-star ranking from 11/05 to 5/09.*

***CPHYX 4- or 5-star rating from 4/03 to 5/09. Past performance is no guarantee of future results.*

# Biographies (cont.)

**Tim Black, JD**

Mr. Black is the Chief Operating Officer and Chief Compliance Officer for SiM and is responsible for day to day operations and SEC compliance matters. Mr. Black has 20+ years of experience in regulatory and compliance matters in various roles in the investment industry. He is a former partner of Integra Ventures, a federally licensed Small Business Investment Company (SBIC), where Mr. Black was responsible for regulatory compliance and oversight management for the firm. Mr. Black is an attorney whose prior practice focused on corporate and securities matters, including issues relating to investment advisers and broker dealers. Mr. Black holds a BA from Colorado College and a JD, with honors, from Seattle University.

**Roger Landes**

Mr. Landes is a Compliance Officer here at SiM. Mr. Landes has a 20+ year history in the Investment Advisory Industry. Prior to joining the firm in 2023, Mr. Landes was an Associate Director of Compliance at SLC Management, a Boston based Registered Investment Advisor where he was responsible for compliance oversight and testing. Prior to SLC Management, Mr. Landes was Chief Compliance Officer for Prime Advisors, Inc. a locally based Fixed Income Advisor. Mr. Landes was responsible for all aspects of the compliance program. Roger attended Washington State University where he studied Business and Economics.

**Greg Holmes, CFA**

Mr. Holmes is a high yield trader for SiM. Prior to joining SiM in 2022, Mr. Holmes was a wealth manager for Heritage Bank where he provided investment management and financial planning for individuals and businesses. Mr. Holmes holds a BA in Finance from Washington State University.

**Lauren Reese, MBA**

Ms. Reese is an Operations and Reporting Associate for SiM and is responsible for day-to-day high yield portfolio operations and reporting. Prior to joining SiM in 2023, Ms. Reese received her MBA from Oregon State University studying Corporate Finance.

# Appendix Exhibit 1 (Continued)

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