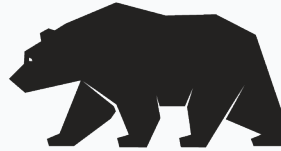




Adam Schwartz

Chief Investment Officer, Black Bear Value Partners





BLACK BEAR
VALUE PARTNERS

**CREDIT ETF'S: CAVEAT EMPTOR
BEST IDEAS 2019, HOSTED BY MOI GLOBAL**

January 2019

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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

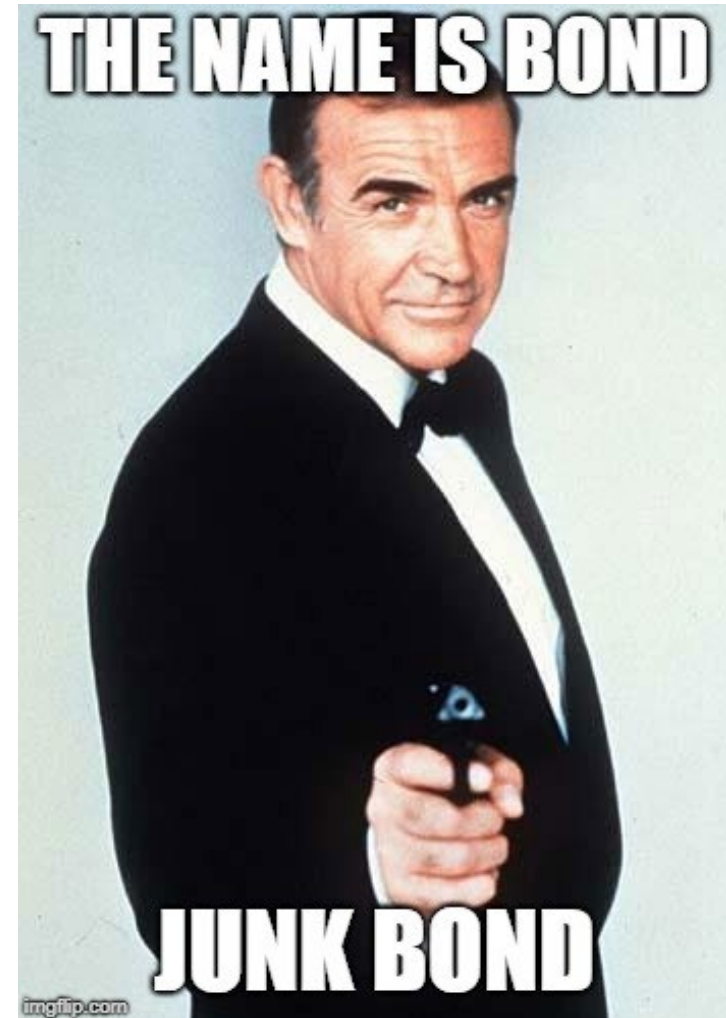
- Lower fees
- Significant personal investment
- Invest with a margin of safety
- Capital preservation is critical
- Performance driven culture
- Longer term capital base
- Patience and disciplined capital allocation

Portfolio Manager

- Led by Adam Schwartz, a 16 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

CREDIT ETF'S – LETHAL WEAPONS

- 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

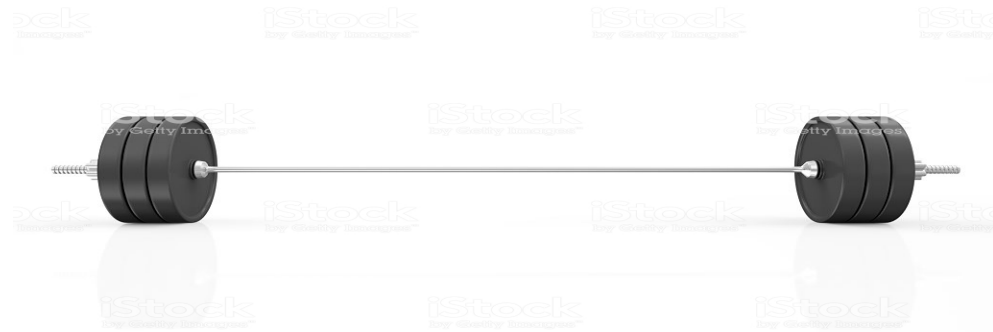


ROUGH STATS ON HY ETF'S

- ~7.4% yield
 - ~4 year duration
 - ~500 bps spread to treasuries assuming NO losses
- Assuming historical losses of 2% **yield is ~5%**
 - ~300 bps spread
- Credit breakdown:
 - 43% BB
 - 42% B
 - 13% CCC or lower

INVESTMENT GRADE BONDS

- ~4% yield
 - ~8 year duration
 - ~140 bps spread to treasuries assuming NO losses
- Assuming historical losses of 0.5% **yield is ~3.5%**
 - 80 bps spread to the 10Y
- Top issuers:
 - Top tier financials: JPM, Goldman, BofA
 - Tech: Apple, Microsoft
 - TMT: AT&T, Comcast
- So why is this an interesting short?? Here's a visual hint:
- Credit breakdown:
 - 3% AAA
 - 8% AA
 - 41% A
 - 49% BBB or worse



HOW DOES THE SAUSAGE GET MADE?



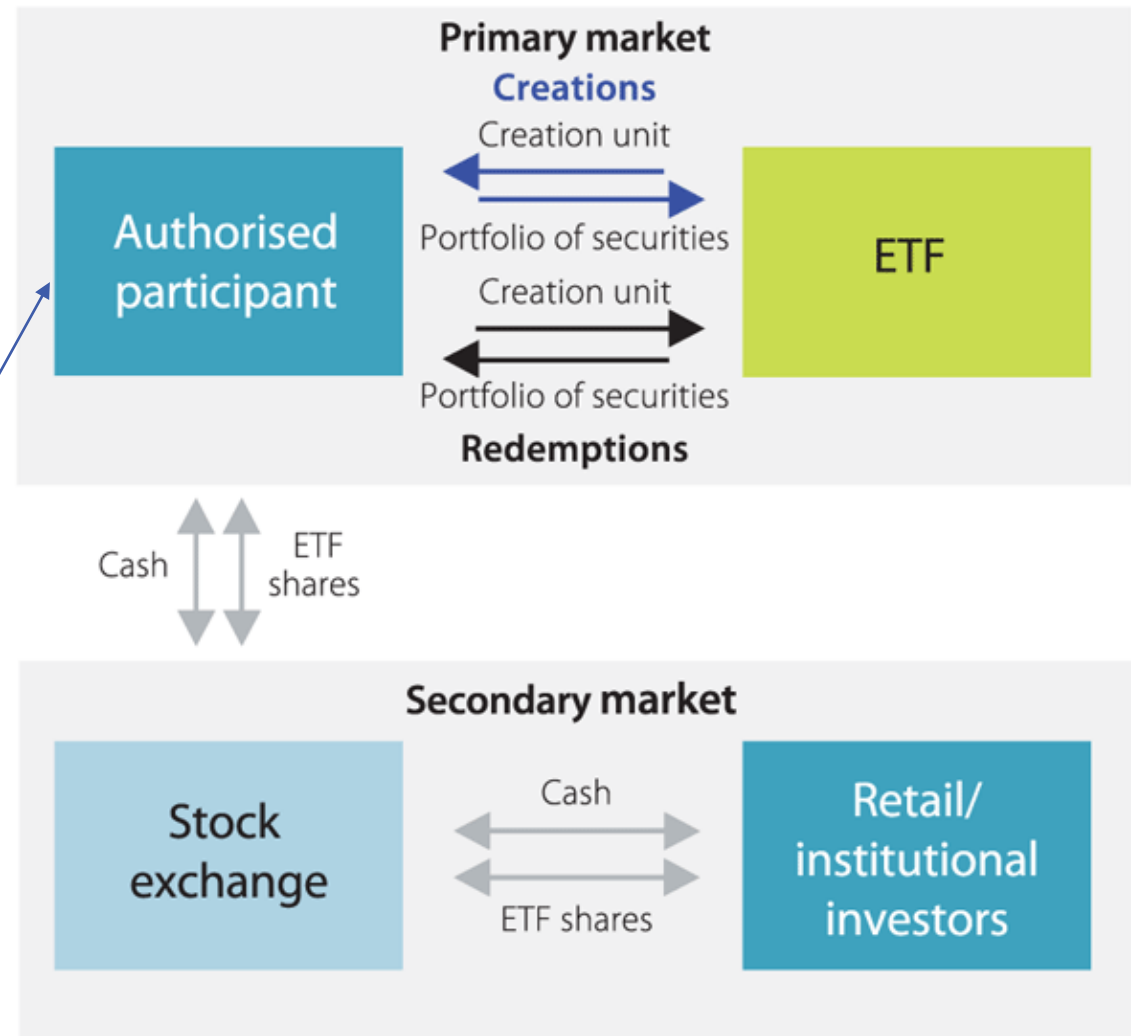
HOW DOES THE SAUSAGE GET MADE?

- 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
- **“True liquidity is how easily you can sell an asset – and at what price – when you're forced to.” - Howard Marks**

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...during rocky times credit markets are not always liquid
- If an ETF trades at a discount to NAV, market makers are supposed to “arb” and close the discount – this only works if there is liquidity in the cash bond market.

ETF Creation and Redemption Process



Source: RBA

SLEEPING AT NIGHT – DAILY LIQUIDITY!

“Our liquidity is fine. As a matter of fact, it’s better than fine. It’s strong.” – Ken Lay

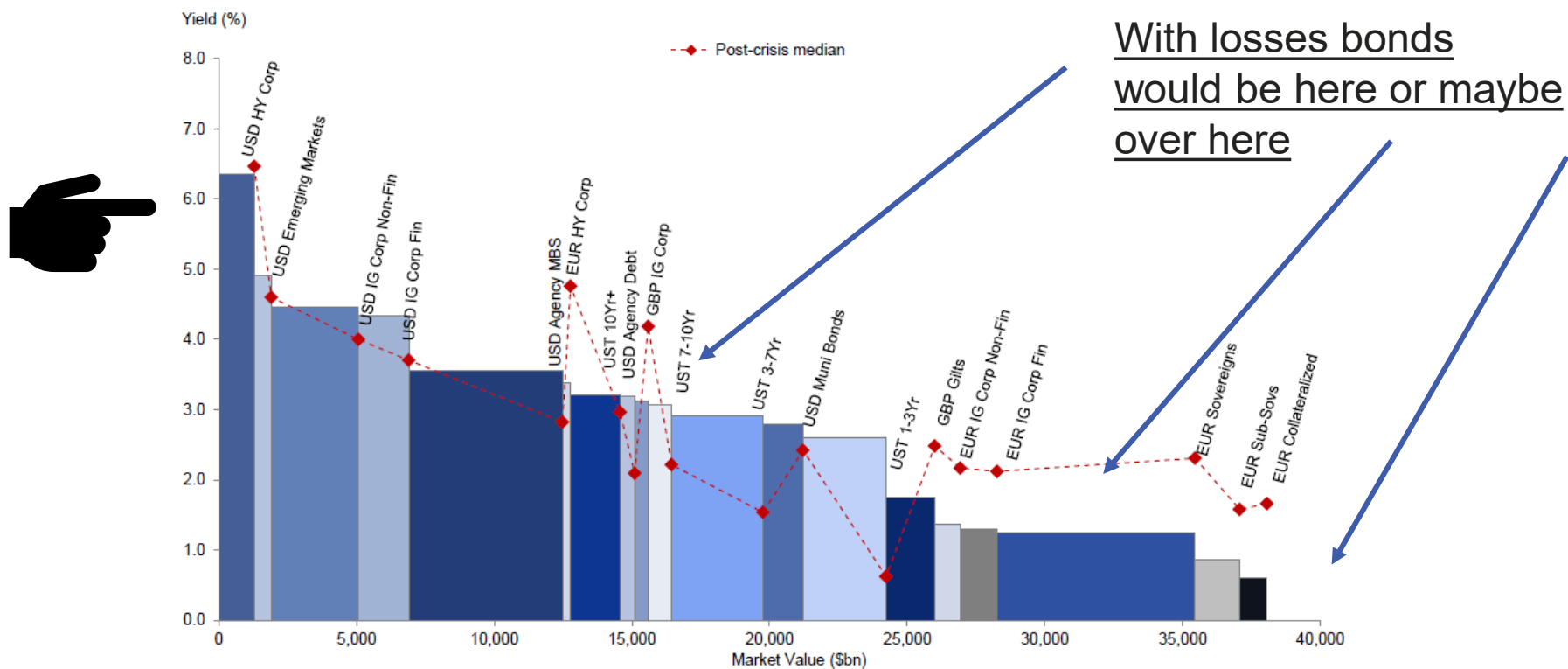
- What happens if there is limited liquidity for the underlying cash bonds?
- What happens when people expect an asset to have liquidity (the ETF) when the underlying asset (the bonds) are less liquid?
- Will they sell the “better” bonds resulting in lower-quality securities remaining behind?
- Who will the market makers sell their bonds to?
 - Limited bank balance sheets/prop desks
- NAV’s may not be trusted and the discount to NAV could be substantial – creates circular trust issue

FIXED INCOME ALTERNATIVES

- HY looks higher yielding – loss adjusted is less attractive
- IG already looks less attractive with or without losses

Yields across global fixed income markets

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



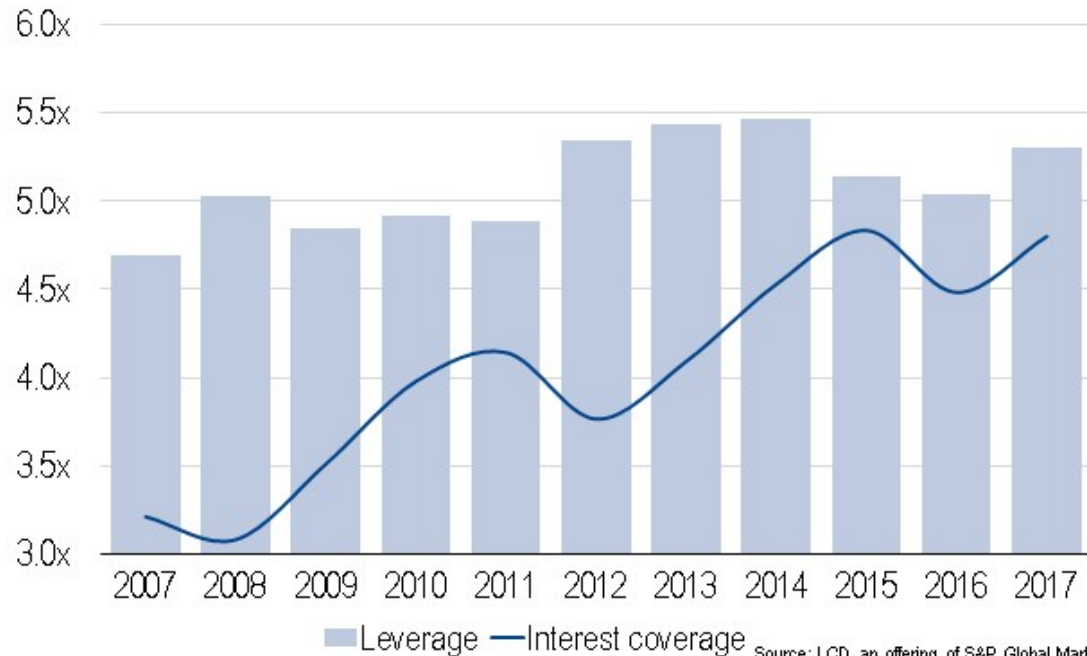
Source: iBoxx, Bloomberg Barclays, Goldman Sachs Global Investment Research

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?

The Good News: Interest Coverage at 10 Year High

Average Leverage & Interest Coverage (S&P/LSTA Leveraged Loan Index)



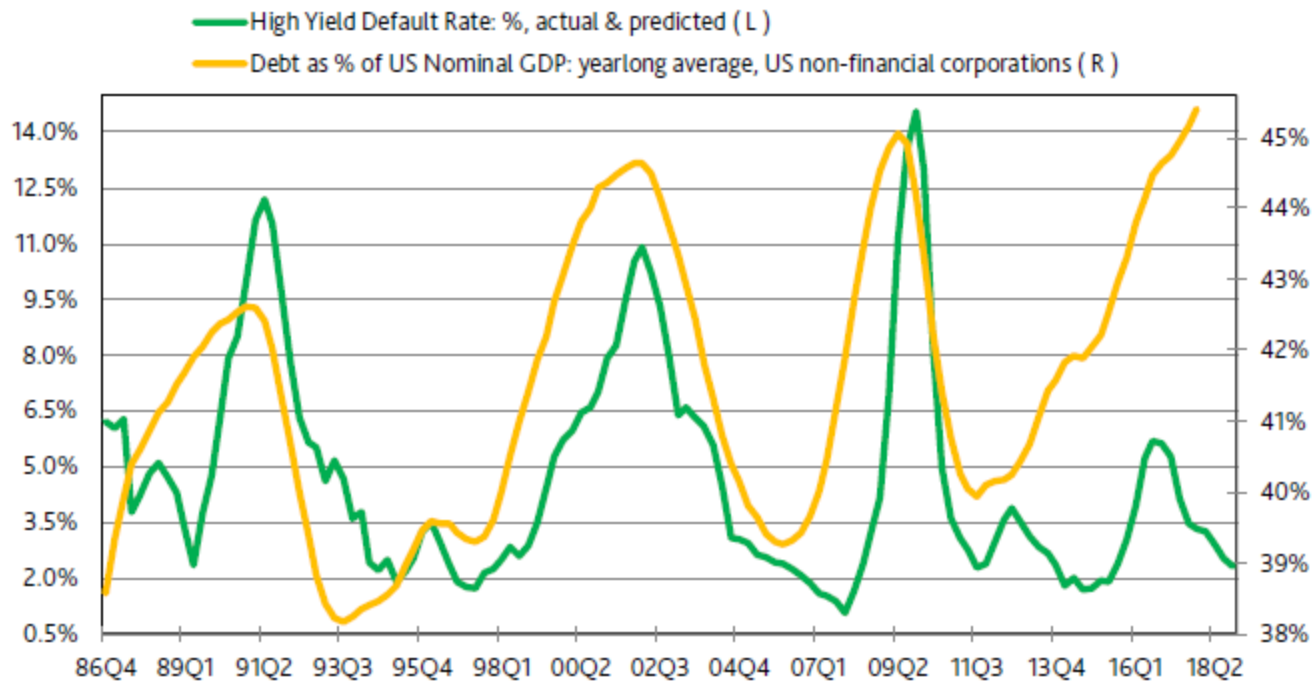
S&P Global
Market Intelligence

Source: LCD, an offering of S&P Global Market Intelligence
Chart as of 3.20.2018.

RISK/REWARD

- More debt usually means more losses but recent history and expectations are less losses.
 - Debt = yellow - HIGHER
 - Default = green - LOWER

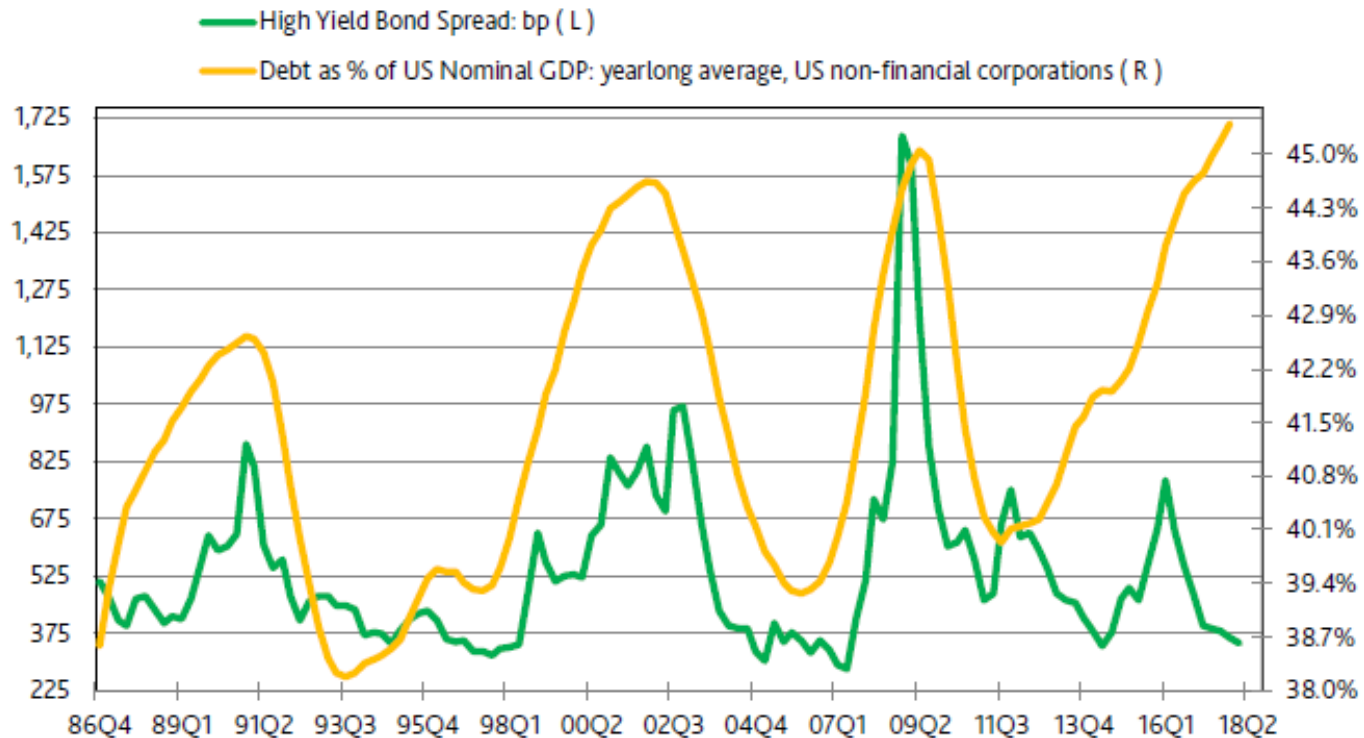
Figure 2: Recent Default Rate and Its Projected Trend Defy Record Ratio of Corporate Debt to US GDP
sources: Moody's Analytics, Federal Reserve



MORE RISK...BETTER RETURN?

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

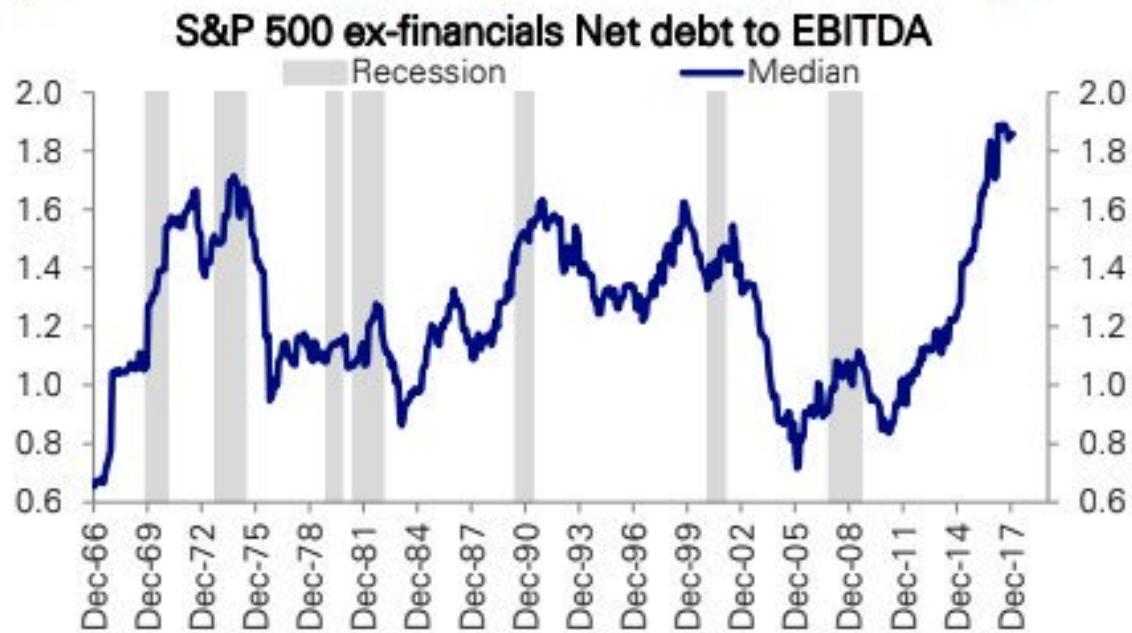
Figure 3: Ultra-Thin High-Yield Bond Spread Shrugs Off Record Ratio of Corporate Debt to US GDP
source: Moody's Analytics, Federal Reserve



COMPANIES ARE BORROWING A LOT!

- Leverage is at a 50 year high

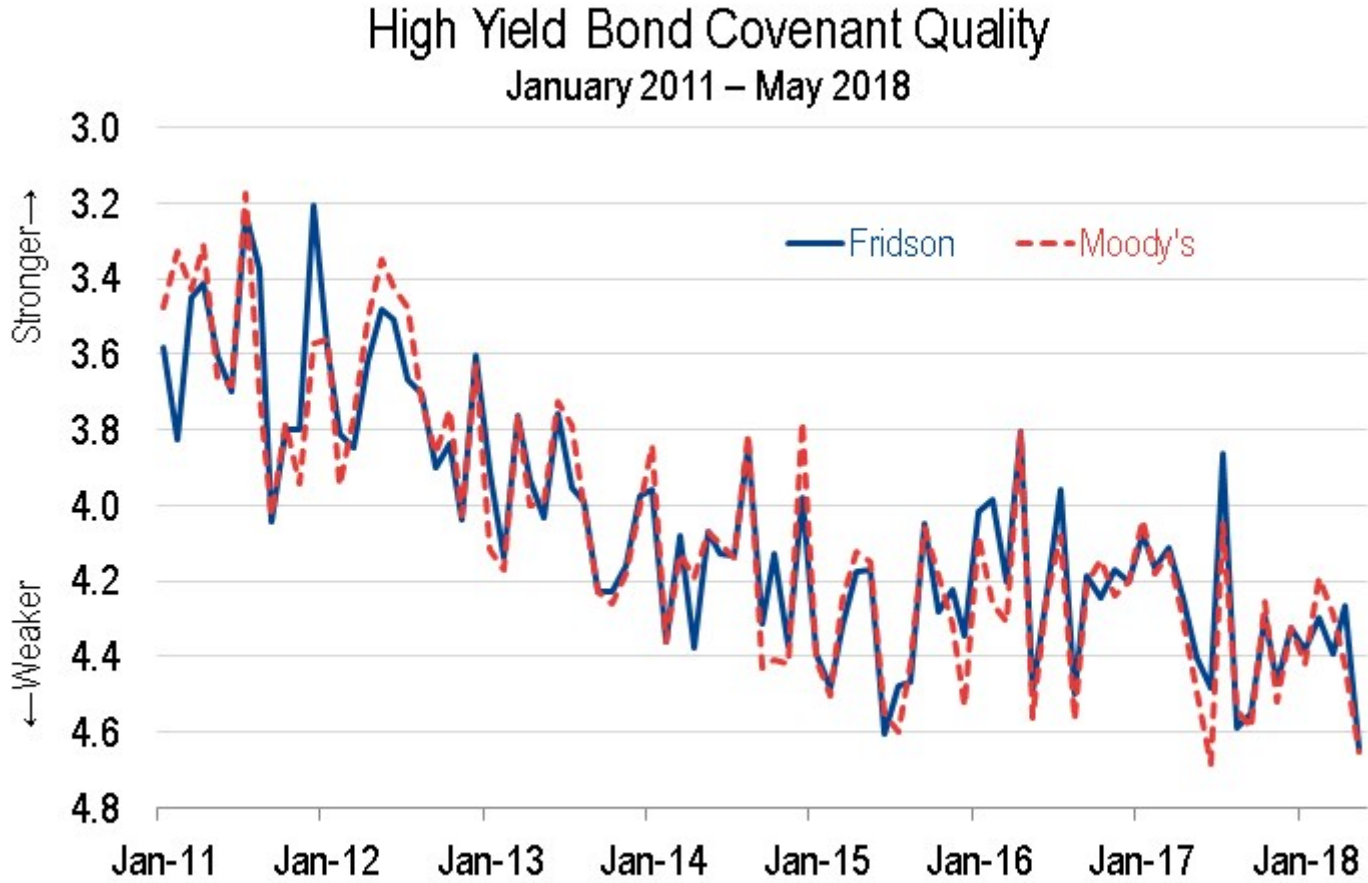
Figure 12: Median company leverage has risen sharply to 50 year highs



Source: Compustat, Deutsche Bank

WEAK COVENANTS

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



Sources: FridsonVision LLC; Moody's Investors Service

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
 - Works for small changes in rates
 - 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? As rates/premiums rise the bonds duration can extend as they cannot be refinanced – convexity kicks in implying a bigger drop 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.

HY CREDIT SHORT UP/DOWN EXAMPLE

- Options can provide more leverage (5+ to 1)
- T-bills “rebate” ~2% or 30+% of negative carry

1Y Up/Down								
			ORDERLY			NOT ORDERLY		
			Down	Base	Up	Down	Base	Up
Current Nominal Yield			7.4%	7.4%	7.4%	7.4%	7.4%	7.4%
Net Losses			2.5%	4.0%	5.5%	2.5%	4.0%	5.5%
Current Net Yield			4.9%	3.4%	1.9%	4.9%	3.4%	1.9%
Duration			4.2	4.2	4.2	4.2	6.0	6.0
Current 5Y UST Yield			2.6%	2.6%	2.6%	2.6%	2.6%	2.6%
Current Spread to 5Y UST			2.3%	0.8%	-0.7%	2.3%	0.8%	-0.7%
UST Yield Change			-1.0%	0.8%	1.5%	-1.0%	0.8%	1.5%
Spread Change			0.5%	2.5%	4.5%	1.0%	3.5%	6.0%
Implied 5Y YST Yield			1.6%	3.4%	4.1%	1.6%	3.4%	4.1%
Implied Net Yield			4.4%	6.7%	7.9%	4.9%	7.7%	9.4%
Implied Spread to UST			2.8%	3.3%	3.8%	3.3%	4.3%	5.3%
New Bond Px			102.1	86.35	74.8	100	74.5	55
Carry			-7.4	-7.4	-7.4	-7.4	-7.4	-7.4
T-Bill "Rebate"			2.0	2.0	2.0	2.0	2.0	2.0
Total PNL			-7.5	8.25	19.8	-5.4	20.1	39.6
P/L% - Simple			-8%	8%	20%	-5%	20%	40%

Note: Not Orderly assumes some element of convexity so duration expands by 50% to 6.

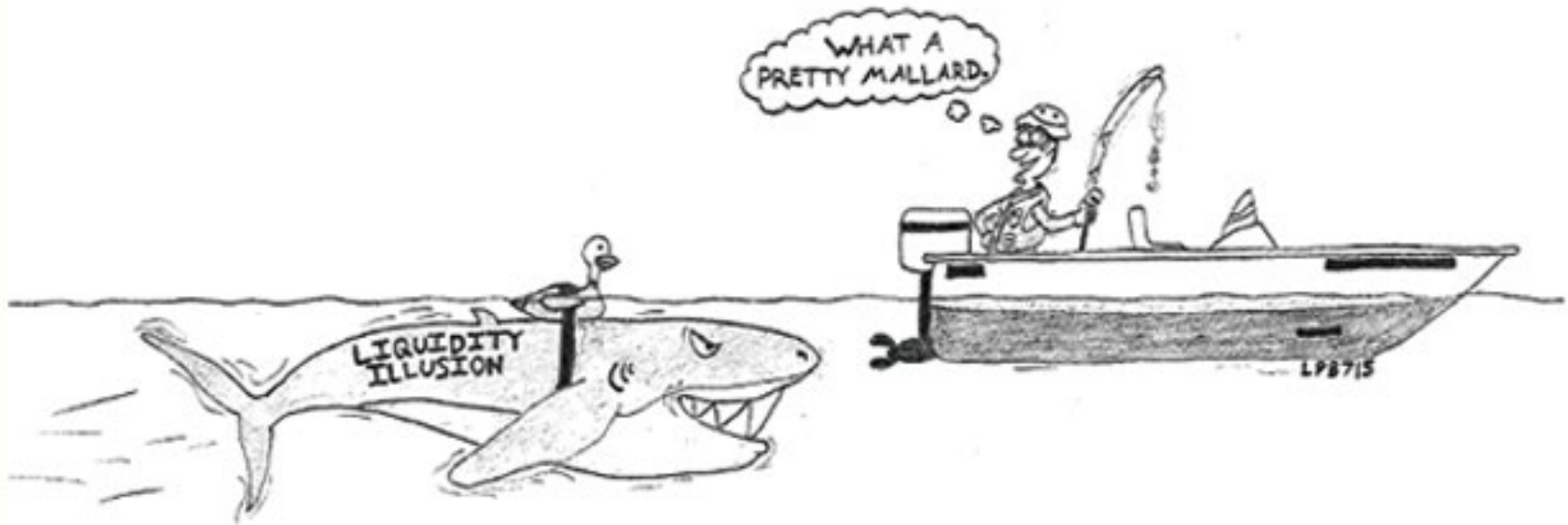
IG CREDIT SHORT UP/DOWN EXAMPLE

- T-bills “rebate” ~2% or 30+% of negative carry

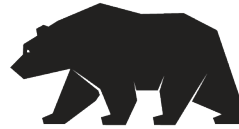
1Y Up/Down								
			ORDERLY			NOT ORDERLY		
			Down	Base	Up	Down	Base	Up
Current Nominal Yield			4.0%	4.0%	4.0%	4.0%	4.0%	4.0%
Net Losses			0.5%	0.8%	1.0%	0.5%	0.8%	1.0%
Current Net Yield			3.5%	3.3%	3.0%	3.5%	3.3%	3.0%
Duration			8.0	8.0	8.0	8.0	10.0	10.0
Current 7Y UST Yield			2.7%	2.7%	2.7%	2.7%	2.7%	2.7%
Current Spread to 7Y UST			0.8%	0.5%	0.3%	0.8%	0.5%	0.3%
UST Yield Change			-1.0%	1.0%	2.0%	-1.0%	1.0%	2.0%
Spread Change			0.5%	1.5%	2.5%	0.5%	2.0%	2.0%
Implied 7Y YST Yield			1.7%	3.7%	4.7%	1.7%	3.7%	4.7%
Implied Net Yield			3.0%	5.8%	7.5%	3.0%	6.3%	7.0%
Implied Spread to UST			1.3%	2.0%	2.8%	1.3%	2.5%	2.3%
New Bond Px			104	80	64	104	70	60
Carry			-4.0	-4.0	-4.0	-4.0	-4.0	-4.0
T-Bill "Rebate"			2.0	2.0	2.0	2.0	2.0	2.0
Total PNL			-6.0	18.0	34.0	-6.0	28.0	38.0
P/L% - Simple			-6%	18%	34%	-6%	28%	38%

CONCLUSION

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



CONTACT DETAILS



Black Bear Value Partners, LP
4601 Ponce De Leon Blvd. Suite 300
Coral Gables, FL 33146

Adam@BlackBearFund.com
Cell: (646) 821-1854
Office: (786) 605-3019