OAKTREE INSIGHTS

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# SPECIAL EDITION: NAVIGATING CYCLES

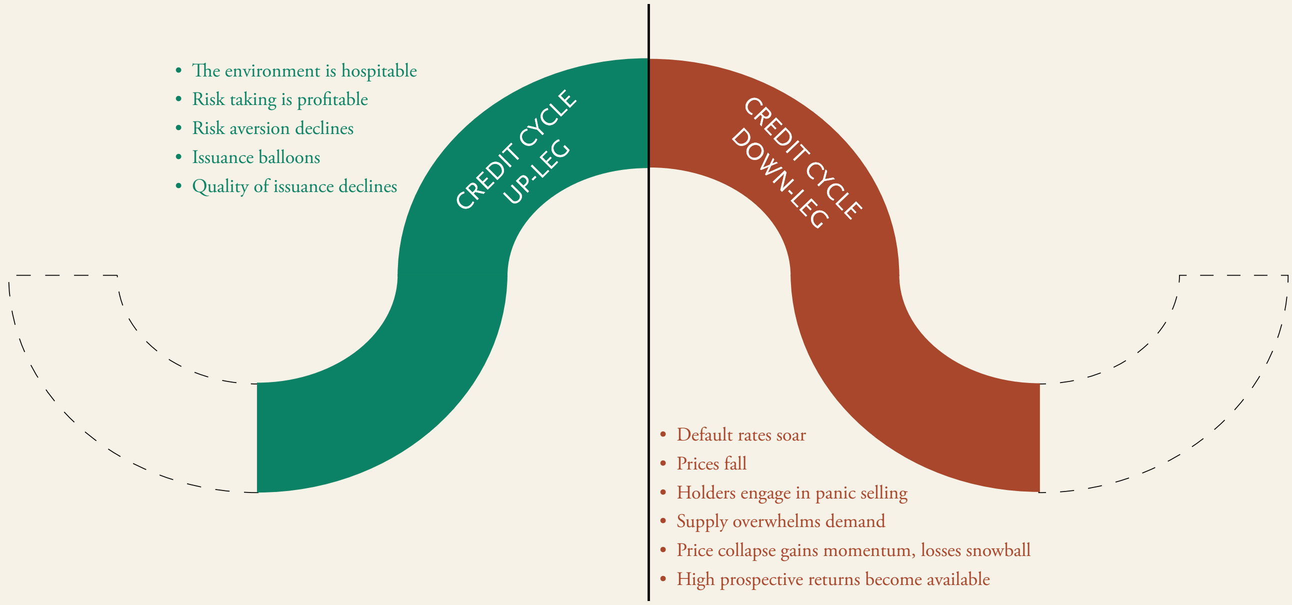
OAKTREE

333 S. GRAND AVE 28TH FLOOR, LOS ANGELES, CA 90071 | (213) 830-6300 | WWW.OAKTREECAPITAL.COM

# NAVIGATING CYCLES

## FOREWORD

*Mark Twain is reputed to have said, "History doesn't repeat itself, but it does rhyme." This certainly holds true in the investment world. Due to the tendency of investors to forget lessons and repeat behavior, the supply of investment opportunities is cyclical in nature. Howard and I have been partners since 1987, and together we have lived through three very pronounced credit cycles. Each of these – like any cycle – has had a repeating up- and down-leg caused by its predecessor and characterized by the following stages:*




*I recently sat down with a diverse group of Oaktree investment professionals to discuss cycles, both past and present. I was joined by Sheldon Stone (Principal and Portfolio Manager, U.S. and Global High Yield Bonds), Edgar Lee (Portfolio Manager, Strategic Credit), Jordon Kruse (Co-Portfolio Manager, Global Principal), Armen Panossian (Co-Portfolio Manager, U.S. Senior Loans) and Rajath Shourie (Co-Portfolio Manager, Distressed Opportunities). What follows is an edited transcript of our discussion.*

**– Bruce Karsh,**
**Co-Chairman and Chief Investment Officer**

**Bruce Karsh: What are the key cycles in your investment area and in what stage are we in for the cycles that matter most to you?**

**Sheldon Stone,** *Principal and Portfolio Manager, U.S. and Global High Yield Bonds*: The two cycles most relevant to high yield bond investors are the economic cycle and the credit cycle. Today, I believe we are in the early innings of a down-leg in both of these cycles.

Our High Yield Bond group also monitors the cycles that are unique to each business and determine supply and demand for their products.

**Armen Panossian,** *Co-Portfolio Manager, U.S. Senior Loans*: The cycles Sheldon mentions (the economic and credit cycles) are also important to senior loan investing. In addition, CLO formation activity – or the CLO cycle – is an important element in understanding demand for senior loans. CLOs hold about 50% of all senior loans in the U.S. market, so the pace of CLO formation is a very critical determinant of the demand for new issue loans coming to market. Relative to 12 or 24 months ago, we've seen an increase in the yield of liabilities across all parts of a CLO's capital structure. As a result, demand for CLO equity has declined, slowing down CLO formation.

This has contributed to a decline in U.S. senior loan new issuance and secondary-market trading.

**Bruce Karsh: How does this credit cycle resemble and differ from past credit cycles?**

**Rajath Shourie,** *Co-Portfolio Manager, Distressed Opportunities*: The down-leg of the current cycle feels most like the down-leg we experienced in the early 2000s, when too much capital came into a popular industry; that industry blew up; and the dislocation spread to other industries. In the early 2000s, telecom was the darling industry that went bust. Today it is energy. In the early 2000s, a majority of the high yield bonds issued by telecom companies defaulted, and unless oil prices make a major recovery, today's exploration and production companies are likely to face a similar fate.

**Jordon Kruse,** *Co-Portfolio Manager, Global Principal*: I'll focus on a comparison of the current down-leg to the one we experienced in 2008-09. They are similar in that both followed long periods of significant debt issuance, but different in that there is far less systemic risk today than there was in 2008-09. A major driver of that risk was the substantial amount of bad mortgage securities held by large financial institutions that played a major role in the financial system at large.

*"In the early 2000s, telecom was the darling industry that went bust. Today it is energy."*
*– Rajath Shourie, Co-Portfolio Manager, Distressed Opportunities*

**Bruce Karsh: What is your expectation for defaults this year?**

**Sheldon Stone**: The 2016 default rate for U.S. high yield bonds is projected to increase to between 5 and 6%. This compares to the 2015 default rate for U.S. high yield bonds of 2.8% and the 30-year average of 4%. While this 2016 estimate is higher than what we've seen since 2009, it is not meaningfully higher than normal observations.

As you would likely guess, defaults this year already have been—and will be—heavily impacted by oil prices. I believe that easily two-thirds, or maybe even three-quarters, of the defaults this year will stem from energy-related issuers.

**Bruce Karsh: Given your views on past and present cycles, how are you positioning your portfolios?**

**Armen Panossian**: In our U.S. Senior Loans strategy, we are adopting a more diversified and defensive approach, while managing our exposure to energy and commodities.

**Rajath Shourie**: During the dislocation we saw in January through mid-February of this year, we were able to invest in a diversified set of high-quality, public-debt opportunities. We invested in sectors where the distress was more palpable, and we focused on higher-quality companies. Similar to what Armen mentioned, the Distressed Opportunities strategy is treading with caution when investing in energy and commodities. We are also looking to be more aggressive when investing in sectors with less of a connection to the current downturn's main drivers (e.g., China, low oil prices).

**Edgar Lee,** *Portfolio Manager, Strategic Credit*: In our Strategic Credit accounts, we are emphasizing seniority and security. We have taken profits on and traded out of high yield bonds following their strong performance thus far in 2016 and have redeployed those proceeds into more senior securities, and in particular, bank debt. Direct lending remains attractive as well, and we are looking to continue to add private loans to our portfolio in the coming months.

**Jordon Kruse**: The current market has afforded our strategy the opportunity to focus on secondary purchases. Currently, the most interesting opportunity set for us is middle-market companies that have exposure to energy. While we have avoided investing directly in exploration and production companies, our team has looked at investments in manufacturing and service businesses that have 15% to 30% of their revenues tied to commodities, but still generate a substantial amount of revenues in areas of the economy not particularly affected by the commodity cycle. We expect many of these businesses will restructure, and we will end up with a control stake.

**Bruce Karsh: How has China's slowdown influenced the cycle we're currently living in?**

**Rajath Shourie**: China is a big driver of demand in the sectors most central to this cycle, including energy, commodities, metals and mining. While there is no question that we are going to look to actively invest in these sectors, we will do so carefully, as the outlook for

China seems murky.

**Armen Panossian**: In the Distressed Debt group, we talk about building an inventory of low-quality debt as a growing pile of kindling, preparing for a bonfire of distress once economic weakness ignites it. I think China will be what gets the kindling lit this time.

**Jordon Kruse**: Consistent with Oaktree's investment philosophy, in the Global Principal area we are more micro than macro investors. As a result, we are focused on how China's slowing has positively or negatively impacted specific businesses. In the early 2000s, a significant aspect of our team's analysis and underwriting included calculating the impact that the migration of manufacturing to China would have on a business over the long term. Today, we are more focused on understanding a business's revenue exposure to China. In many cases, low commodity prices are positive for U.S. businesses.

**Bruce Karsh: Outside of China, what factors do you think are exerting the greatest impact on the current market environment?**

**Sheldon Stone**: The obvious ones are low energy and commodity prices; however, those are linked to China. The other one worth highlighting is liquidity. Current trading markets are significantly less liquid, causing rapid changes from a buyer's market to a seller's without large trading volumes.

*"Current trading markets have significantly less liquidity, causing prices to move without large trading volumes."*

*– Sheldon Stone, Principal and Portfolio Manager, U.S. and Global High Yield Bonds*

We estimate that today, banks are carrying about 20% of their 2007 peak inventory of senior loans and high yield bonds. As a result, banks are now looking for trades to cross, rather than putting their capital at risk. It doesn't take much selling these days to move bond prices a fair amount.

**Rajath Shourie**: I completely agree with Sheldon. Prices have recently been declining dramatically because there's a buyers' strike at play, not because there is a lot of supply from forced sellers.

**Bruce Karsh: Is a tremendous buying opportunity imminent or likely much further away? Do you think Oaktree's substantial dry powder will be deployed over the next two years?**

**Rajath Shourie**: Our Distressed Opportunities strategy currently has a lot of dry powder. In two years, I think we will be talking about having had a good buying opportunity, and we will have been happy to have spent some of our dry powder. That said, in two years we may not reflect on the period as favorably as we would in a scenario in which we'd spent all of our dry powder, realized every investment and made a profit. It is quite possible that two years from now, we might still be in the middle of a good buying opportunity. In other words, we foresee a long, gradual cycle, not cathartic.

**Edgar Lee**: I think one of the most important investing lessons I have learned at Oaktree is that you can't call the bottom, so you have to be willing to average down and buy on the way to it. When the market moves lower over the next two years, we need to identify those securities that are trading at a discount to their intrinsic value in order to generate great returns for the long run. As long as we continue to stay committed to investing in credits with good value as they become cheaper, we will create a long-term advantage.

**Jordon Kruse**: For the Global Principal strategy, I think the next couple of years will present a great buying opportunity if there is an exogenous event "igniting the bonfire" – like Lehman's bankruptcy filing did in 2008 – as Armen alluded to. In the absence of that type of event, I think we will see a good buying opportunity because of the tremendous amount of debt outstanding today. So many low-quality credit names are out there, and some percentage of those names won't make it. Our team is targeting high-quality but over-leveraged companies we think will to need to restructure – ultimately these are the kinds of investments we think represent good buying opportunities at any time in the cycle.

## BIOGRAPHIES

### BRUCE KARSH

*Co-Chairman and Chief Investment Officer*

Mr. Karsh is Oaktree's Co-Chairman and one of the firm's co-founders. He also is Chief Investment Officer and serves as portfolio manager for Oaktree's Distressed Opportunities and Value Opportunities strategies. Prior to co-founding Oaktree, Mr. Karsh was a managing director of TCW Asset Management Company, and the portfolio manager of the Special Credits Funds from 1988 until 1995. Prior to joining TCW, Mr. Karsh worked as Assistant to the Chairman of SunAmerica, Inc. Prior to that, he was an attorney with the law firm of O'Melveny & Myers. Before working at O'Melveny & Myers, Mr. Karsh clerked for the Honorable Anthony M. Kennedy, then of the U.S. Court of Appeals for the Ninth Circuit and presently Associate Justice of the U.S. Supreme Court. Mr. Karsh holds an A.B. degree in economics summa cum laude from Duke University, where he was elected to Phi Beta Kappa. He went on to earn a J.D. from the University of Virginia School of Law, where he served as Notes Editor of the Virginia Law Review and was a member of the Order of the Coif. Mr. Karsh is Chairman of the Board of Tribune Media Company and serves on the boards of a number of privately held companies. He is a member of the investment committee of the Broad Foundations. Mr. Karsh is Trustee Emeritus of Duke University, having served as Trustee from 2003 to 2015, and as Chairman of the Board of DUMAC, LLC, the entity that managed Duke's endowment, from 2005 to 2015.

### SHELDON STONE

*Principal and Portfolio Manager, U.S. and Global High Yield Bonds*

Mr. Stone is the head of Oaktree's high yield bond area. In this capacity, he serves as co-portfolio manager of Oaktree's U.S. High Yield Bond and Global High Yield Bond strategies and has supervisory responsibility for European High Yield Bonds. Mr. Stone, a co-founding member of Oaktree in 1995, established TCW's High Yield Bond department with Howard Marks in 1985 and ran the department for ten years. Prior to joining TCW, Mr. Stone worked with Mr. Marks at Citibank for two years where he performed credit analysis and managed high yield bond portfolios. From 1978 to 1983, Mr. Stone worked at The Prudential Insurance Company where he was a director of corporate finance, managing a fixed income portfolio exceeding $1 billion. Mr. Stone holds a B.A. degree from Bowdoin College and an M.B.A. in accounting and finance from Columbia University. Mr. Stone serves as a Trustee of Colonial Williamsburg Foundation and Bowdoin College.

### EDGAR LEE

*Portfolio Manager, Strategic Credit*

Mr. Lee serves as the portfolio manager for Oaktree's Strategic Credit strategy. Mr. Lee was also an investment professional within the Distressed Debt group and has led a number of the group's investments in the media, technology and telecom industries. Prior to joining Oaktree in 2007, Mr. Lee worked within the Investment Banking division at UBS Investment Bank in Los Angeles, where he was responsible for advising clients on a number of debt and preferred stock restructurings, leveraged financings, buy-side and sell-side M&A, mezzanine financings and recapitalizations. Before that, he was employed within the Fixed Income division at Lehman Brothers Inc. Prior experience includes work at Katzenbach Partners LLP and the Urban Institute. Mr. Lee received a B.A. degree in economics from Swarthmore College and an M.P.P. with a concentration in applied economics from Harvard University. Previously, Mr. Lee served on the boards of Nine Entertainment and Charter Communications.

## BIOGRAPHIES (CONTINUED)

### JORDON KRUSE

*Co-Portfolio Manager, Global Principal*

Mr. Kruse is a managing director and co-portfolio manager within the Global Principal Group. He is responsible for management of the U.S. Global Principal team and all of its investing activities. In addition, Mr. Kruse leads the team's efforts in the industrials sector, where he is responsible for sourcing, analyzing, executing transactions and monitoring portfolio companies. Prior to joining Oaktree in 2001, Mr. Kruse was an attorney at the law firm of Kirkland & Ellis where his practice focused on mergers and acquisitions, corporate finance and private equity. Mr. Kruse received a B.A. degree in history and government from the University of Virginia and a J.D. from the Northwestern University School of Law where he was a member of the Order of the Coif and served as a Note and Comment Editor of the Law Review. Mr. Kruse is a member of the State Bar of Illinois. He currently serves as a member of the Boards of Directors of Cyanco, Isola, Dayton Superior and Tecta, and has previously served as a director of numerous former investments in a broad range of industries. In addition, Mr. Kruse serves of the Board of Directors of Covenant House California, the Board of Trustees of The Children's Bureau of Los Angeles and the Board of Trustees of The College Foundation of the University of Virginia.

### ARMEN PANOSSIAN

*Co-Portfolio Manager, U.S. Senior Loans*

Mr. Panossian joined Oaktree in 2007 as a senior member of its Distressed Debt investment team where he contributed to the analysis and portfolio construction of its funds. In 2014, he joined the U.S. Senior Loan strategy as a co-portfolio manager. Mr. Panossian joined Oaktree from Pequot Capital Management, where he spent three years, most recently as a vice president, working on their distressed debt strategy. Prior experience includes two years as a financial analyst in the mergers and acquisitions department at Morgan Stanley Dean Witter. Mr. Panossian received a B.A. degree in economics with honors and distinction from Stanford University, where he was elected to Phi Beta Kappa. He then went on to receive an M.S. degree in health service research from Stanford Medical School and J.D. and M.B.A. degrees from Harvard Law School and Harvard Business School. He is a member of the State Bar of California.

### RAJATH SHOURIE

*Co-Portfolio Manager, Distressed Opportunities*

Mr. Shourie is a managing director and co-portfolio manager within Oaktree's Distressed Debt group. He contributes to the analysis, portfolio construction and management of the Distressed Opportunities and Value Opportunities strategies. Since joining Oaktree in 2002, Mr. Shourie has spent his time investing in distressed debt. He has invested in the airline/aircraft industry for a number of years, and led the firm's investments in financial institutions during the global financial crisis. Mr. Shourie has worked with a number of Oaktree's portfolio companies, and currently serves on the boards of Taylor Morrison (NYSE: TMHC) and specialty REIT STORE Capital (NYSE: STOR). He has been active on a number of creditors' committees, including the steering committee in the restructuring of CIT Group. Prior to joining Oaktree, he was an associate in the Principal Investment area at Goldman, Sachs & Co., and a management consultant at McKinsey & Co. Mr. Shourie earned a B.A. in economics from Harvard College, where he was elected to Phi Beta Kappa. He then went on to receive an M.B.A. from Harvard Business School, where he was a Baker Scholar.

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*Securities in the lower rated categories and comparable non-rated securities are subject to greater risk of loss of principal and interest than higher rated and comparable non-rated securities and are generally considered to be predominantly speculative with respect to the issuer's capacity to pay interest and repay principal. They are also generally considered to be subject to greater risk than securities with higher ratings or comparable non-rated securities in the case of deterioration of general economic conditions. Because investors generally perceive that there are greater risks associated with the lower rated and comparable non-rated securities, the yields and prices of such securities may be more volatile than those for higher rated and comparable non-rated securities. The market for lower rated and comparable non-rated securities is thinner, often less liquid, and less active than that for higher rated or comparable non-rated securities, which can adversely affect the prices at which these securities can be sold and may even make it impractical to sell such securities.*

### *Bank Loans and Participations*

*Bank loans and participations involve the risk of invalidation as a fraudulent conveyance, lender liability claims, environmental liabilities with respect to collateral and limitations on the holder's ability to directly enforce its rights with respect to participations.*

### *Nature of Bankruptcy Proceedings*

*Investing in companies involved in bankruptcy proceedings presents significant risks, foremost of which are the lack of control over certain events, the bankruptcy filing itself may have an adverse impact on the company, the duration of the proceedings are difficult to predict and may be further impacted by delays, the costs inherent in the process are frequently high, creditors can lose their priority and ranking in a variety of circumstances and representation on a creditors committee may subject the creditor to various trading and confidentiality restrictions.*

### *Foreign Investments*

*Investments in securities or obligations of foreign entities involve certain special risks, including social, political or economic instability; the possibility of unfavorable foreign governmental actions; price fluctuations and market volatility; differences in auditing and financial reporting; adverse taxes; and different laws and customs. These factors may increase the likelihood of potential losses being incurred in connection with such investments. Further, because such investments in foreign entities are likely to be denominated in multiple currencies, the fluctuation in currency exchange rates may have an adverse impact on performance.*

### *Convertible Securities*

*Many convertible securities are not rated investment grade. Securities in the lower-rated and non-rated categories are subject to greater risk of loss of principal and interest than higher-rated securities and are generally considered to be predominantly speculative with respect to the issuer's capacity to pay interest and repay principal. They are also generally considered to be subject to greater risk* *than securities with higher ratings in the case of deterioration of general economic conditions. Because investors generally perceive that there are greater risks associated with lower-rated and non-rated securities, the yields and prices of such securities may be more volatile than those for higher-rated securities. The market for lower-rated and non-rated securities is thinner, often less liquid, and less active than that for higher-rated securities, which can adversely affect the prices at which these securities can be sold and may even make it impractical to sell such securities. The limited liquidity of the market may also adversely affect the ability to arrive at a fair value for certain lower-rated and non-rated securities at certain times and could make it difficult to sell certain securities.*

***Stressed Credits***

*Any deterioration of underlying market fundamentals could negatively impact the performance of investments in stressed companies. Changes in general economic conditions, tax rates, operating expenses, interest rates and the availability of debt financing may also adversely affect the performance of such investments. For these or other reasons, investments in stressed companies may become "non-performing" after their acquisition, and during an economic downturn or recession, stressed investments are more likely to go into default than securities of other issuers not experiencing financial stress. Securities of stressed companies are also often less liquid and more volatile than securities of companies not experiencing financial difficulties, often involving a higher degree of credit and market risk.*

***Real Estate Investments***

*The value of real estate-related securities can fluctuate for various reasons. Real estate values can be seriously affected by interest rate fluctuations, bank liquidity, the availability of financing, and by regulatory or governmentally imposed factors such as a zoning change, an increase in property taxes, the imposition of height or density limitations, the requirement that buildings be accessible to disabled persons, the requirement for environmental impact studies, the potential costs of remediation of environmental contamination or damage and the imposition of special fines to reduce traffic congestion or to provide for housing. Income from income-producing real estate may be adversely affected by general economic conditions, local conditions such as oversupply or reduction in demand for space in the area, competition from other available properties, and the owner provision of adequate maintenance and coverage by adequate insurance. Furthermore, certain investments in mortgages, real estate or non-publicly traded securities and private debt instruments have a limited number of potential purchasers and sellers. This factor may have the effect of limiting the availability of these investments for purchase and may also limit the ability to sell such investments at their fair market value in response to changes in the economy or the financial markets.*

***Illiquid Investments***

*Certain strategies will involve the use of illiquid securities or securities which are restricted as to their transferability. Such restrictions may limit the ability to sell such securities at their fair market value.*

***Leverage***

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