Floating Rate Bank Loan Strategy

Newfleet
ASSET MANAGEMENT
A Virtus Investment Partner

MARKET OVERVIEW

After a turbulent end to the first quarter and historic losses in March, the bank loan market rebounded soundly in the second quarter. Loans returned 9.7% for the quarter (Credit Suisse Leveraged Loan Index), retracing roughly 75% of the previous period's losses (-13.2%). The Federal Reserve's massive stimulus plan to combat the economic fallout from COVID-19, and supportive actions by central banks worldwide, buoyed investors' confidence in a sustained recovery, especially as economies began to reopen. In late June, a resurgence of virus cases in certain parts of the U.S. threatened to slow progress on the reopenings and reintroduced some weakness into the markets.

Consistent with a risk-on backdrop, lower quality did better than higher quality over the second quarter with Bs and CCCs (both at +11.5%) outperforming BBs (+6.1%). Higher quality had started off the rally in late March as opportunistic buyers stepped in to take advantage of historically cheap valuations. As continued policy support and an easing of virus-related restrictions boosted sentiment, riskier cohorts assumed the lead as investors focused on lower dollar price loans for total return opportunities (and CLO managers added discounted credits to manage CLO structure tests).

All industries posted positive returns for the second quarter. Energy (+26.4%), transportation/shipping (+15.0%), and metals/minerals (+13.8%), the hardest hit in the first quarter, outperformed in the second quarter along with food & drug (+14.2%) and manufacturing (+12.5%). The more defensive industries, such as cable/wireless video (+3.7%) and wireless communications (+5.1%), underperformed.

Aside from a few weeks of modest inflows, retail redemptions persisted throughout the quarter (roughly $5 billion) though at a much more moderate pace than in March. Demand from retail investors, now less than 5% of the market, is likely to remain soft given the low interest rate environment. Demand from CLOs showed steady improvement over the quarter, though year-to-date issuance is still considerably behind the comparable six-month period in 2019. As the CLO market continues to "heal," a new profile of CLOs has emerged (e.g., smaller, shorter-dated) with more creativity in deal structures.

Despite a surge in June, supply remains weak with gross new issuance of just $46 billion in the second quarter. Due to substantial refinancings/repricings in January and February, gross issuance ($246 billion) is up 56% year over year, while net issuance ($77 billion) is down 32%. Market share gains from high yield and the practical difficulties of doing LBOs and M&A in a post-COVID world has dampened supply and has resulted in a thin forward calendar. Limited supply, however, has aided the technical. In combination with rising CLO issuance, more muted retail outflows, and June quarterly amortization, we expect technicals to be in good shape over the next few months.

Second quarter earnings will be the next important economic milestone in the COVID timeline as the results should provide better visibility on the magnitude of the damage to credit fundamentals and the future path of downgrades and defaults. After surging in April, downgrade activity decreased in May and June but, to this point in time, roughly 35% of the loan market (by par amount outstanding) has been downgraded. The trailing 12-month default rate hit a five-year high of 3.2% in June with expectations that it will go higher as the pandemic continues to take its toll. In the near term, we expect markets to remain relatively flat and move with the headlines. We may be in the calm before the storm with second quarter earnings a potential catalyst for another wave of downgrades and defaults.

The average price of the market closed the second quarter at 89.9, well above the March 23 low of 76.2, but still below the 96.7 price at the start of 2020; the quarter started at 82.8. Prices improved across the risk spectrum with BBs ending the quarter at 95 followed by Bs at 92.4; CCCs closed at 76.4, the highest reading since February. Roughly 49% of performing loans were bid 95 or higher, up from 8% in March. The lower end has also seen improvement with 8% of the market now less than 80, down from 57% in March. Loan spread to a three-year life closed the quarter at Libor+696, a steady improvement from the March wide of L+1076. Spreads remain wide of the lifetime historical average of low/mid Libor+500s, thus marking a reasonably attractive entry point in the space for patient long-term investors.

HOW THE STRATEGY PERFORMED

The Strategy (gross of fees) returned 8.84% in the second quarter versus the 9.71% return of the Credit Suisse Leveraged Loan Index.

Positive Contributors

> Solid credit selection in the consumer non-durables, autos, food/tobacco, and forest products industries.

> Remaining fully invested with the modest use of leverage during the strong second quarter rebound.

Detractors

> Credit selection in the healthcare and utility industries, though not dominated by any particular names.

> Allocation to, and selection within, the cable industry.

> The allocation to the high yield sector as part of the Strategy's liquidity strategy.

CURRENT STRATEGY POSITIONING

The Strategy ended the second quarter with 95% invested in senior secured first lien bank loans, <1% in non-first lien bank loans, and the majority of the remaining exposure in high yield bonds as part of our liquidity strategy.

> We continue to monitor the Strategy's coronavirus-related exposures in terms of both direct and secondary impacts. Our focus is on companies with liquidity, runway, access to capital markets, and generally a good risk/reward balance of having some protection on the downside with good upside potential. We will assess and exit business models that will be permanently damaged by the COVID-19 crisis.

> The Strategy's largest overweights are in forest products, media/telecom-broadcasting, healthcare, and food/tobacco; the largest underweights include information technology, media/telecom-diversified media, financial, and retail.

> We continue to maintain an up-in-quality bias given the uncertainty of the economic recovery. We will, however, take advantage of select opportunities as they arise due to technical dislocations in lower quality credits, particularly as they relate to CLOs having to sell lower quality credits to manage CCC buckets.

> We are comfortable remaining fully invested with modest use of leverage.

OUTLOOK

The containment of the virus and, ultimately, the development of a vaccine are the determining factors in the prospects for bank loans as well as other risk assets. The greatest short-term risk, as indicated above, is second quarter earnings and the severity of the damage to earnings and outlooks. We expect an acceleration in the deterioration of fundamentals and for defaults to rise significantly over the next 12 to 24 months. The importance of credit selection once again has come to the forefront, especially given the second quarter's swift rally in prices that implies that much of the low-hanging fruit has been picked.

The commentary is the opinion of the subadviser. This material has been prepared using sources of information generally believed to be reliable; however, its accuracy is not guaranteed. Opinions represented are subject to change and should not be considered investment advice or an offer of securities.

PORTFOLIO MANAGEMENT

David L. Albrycht, CFA
Industry start date: 1985

Kyle A. Jennings, CFA
Industry start date: 1992

Francesco Ossino
Industry start date: 1996

FIRM OVERVIEW

Newfleet leverages the knowledge and skill of a team of investment professionals with expertise in every sector of the bond market, including evolving, specialized, and out-of-favor sectors. The team employs active sector rotation and disciplined risk management to portfolio construction.

INVESTMENT OPPORTUNITY

Newfleet's senior floating rate strategy is founded on the belief that downside risk can be limited, and thus losses avoided, through two complementary approaches: rigorous credit analysis and active portfolio management.

The strategy seeks competitive total return and income by investing primarily in non-investment grade floating rate bank loans. The strategy is rooted in extensive credit and company analysis with an emphasis on loss avoidance and active management that results in broadly diversified portfolios.

Investment opportunities are carefully screened to identify "best in class" companies with leading market share, superior cash flow, and an appropriate capital structure. Combining this with active management that emphasizes broad diversification across both industry and individual securities generates a portfolio with broadly diversified loan market exposure centered on loss avoidance and adequate liquidity.

INVESTMENT PROCESS

STEP 1 Macroeconomic Analysis

- Identify attractive industries/themes/risk appetite
- Industry analysis – (i.e., state of growth; cyclicality; competitive factors)
- Industry themes – (i.e., new technology/product; secular trends)
- Risk appetite-driven credit cycle phase; technicals/liquidity
- Formal interaction among sector specialists provides insight into trends and conditions across all fixed income sectors which may have bearing on the bank loan space

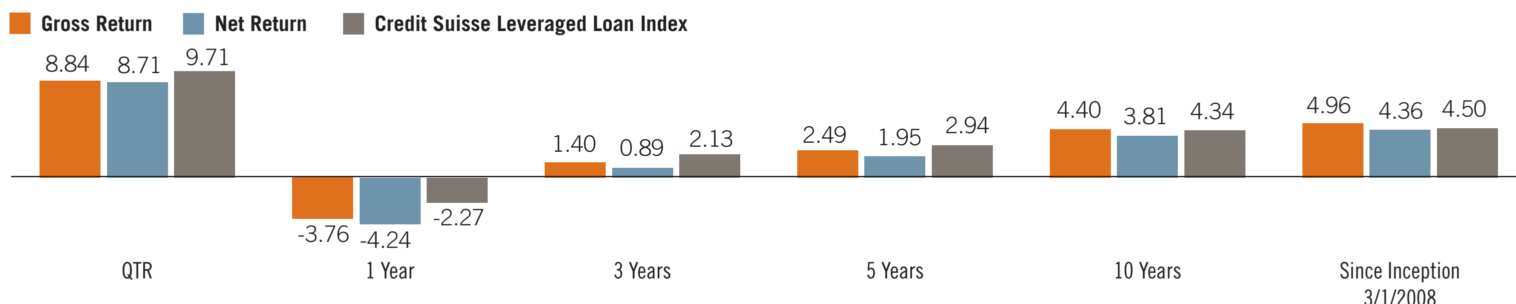
STEP 2 Fundamental Analysis

- Perform extensive credit and company analysis
- Fundamental analysis includes assessment of: credit risk, company management; issue structure; technical market conditions; focus on valuations
- Identify loan characteristics/structures

STEP 3 Portfolio Construction

- Over/underweight industries relative to benchmark based on relative value analysis
- Emphasize broad diversification to limit exposure to an industry or issuer
- Conduct credit monitoring and portfolio review

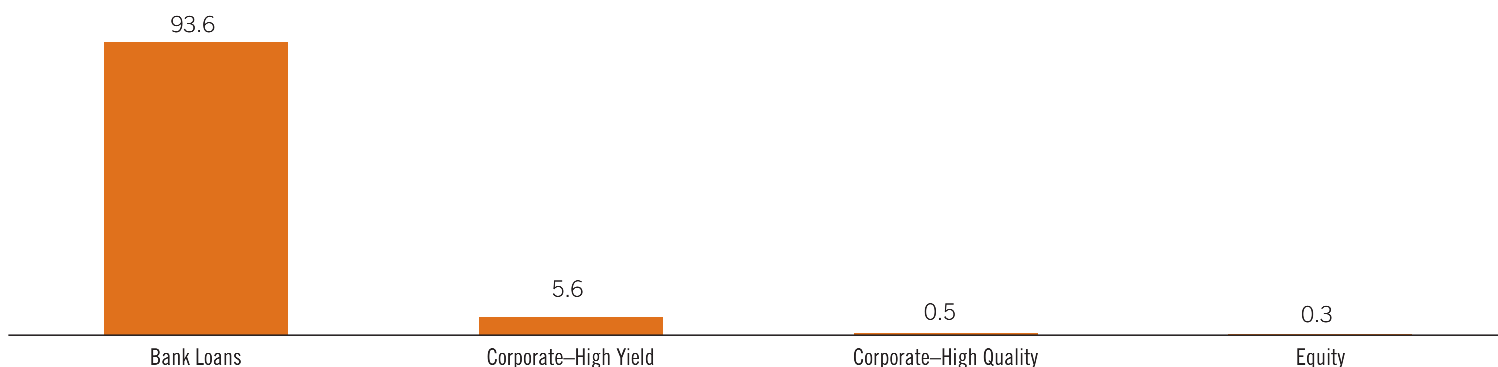
PERFORMANCE (%)



Periods ended 6/30/20. Time periods over one year are annualized. **Past performance is not indicative of future results.** Net return is shown net of maximum management fees.

The Credit Suisse Leveraged Loan Index is a market-weighted index that tracks the investable universe of the U.S. dollar denominated leveraged loans. The index is calculated on a total return basis. The index is unmanaged, its returns do not reflect any fees, expenses, or sales charges, and is not available for direct investment.

SECTOR ALLOCATION



RISK STATISTICS

	1 Year		3 Years		5 Years		10 Years		Since Inception 3/1/2008	
	Portfolio	Index	Portfolio	Index	Portfolio	Index	Portfolio	Index	Portfolio	Index
Sharpe Ratio	-0.30	-0.20	0.01	0.09	0.22	0.29	0.69	0.71	0.63	0.52
Alpha (%)	-1.40	0.00	-0.72	0.00	-0.47	0.00	-0.09	0.00	0.88	0.00
Beta	1.03	1.00	1.04	1.00	1.03	1.00	1.04	1.00	0.88	1.00
R-Squared (%)	99.58	100.00	99.40	100.00	99.03	100.00	98.40	100.00	93.50	100.00
Standard Deviation (%)	14.40	14.00	8.81	8.47	7.05	6.84	5.58	5.30	7.12	7.84
Tracking Error	1.02	0.00	0.76	0.00	0.73	0.00	0.75	0.00	2.07	0.00
Information Ratio	-1.47	NA	-0.97	NA	-0.61	NA	0.08	NA	0.22	NA

RATINGS DISTRIBUTION[1] (%)

	Portfolio
Aaa	0.00
Aa	0.00
A	0.00
Baa	10.88
Ba	33.48
B	48.40
Caa	3.64
Ca	0.19
C	0.27
D	0.18
Not Rated	2.96
Cash	0.00

MATURITY (%)

	Portfolio
Under 3 Years	12.38
3-5 Years	51.33
5-10 Years	36.28
Over 10 Years	0.00

DURATION (%)

	Portfolio
Under 3 Years	95.09
3-5 Years	4.20
5-10 Years	0.72
Over 10 Years	0.00

PORTFOLIO CHARACTERISTICS

	Portfolio
Duration	0.48 yrs
Yield to Worst	7.03%

Sector and ratings distributions are subject to change. Results presented are that of a representative portfolio and are presented as supplemental information to the GIPS Compliant Presentation presented on page 4. Risk statistics are that of the Composite.

Index: Credit Suisse Leveraged Loan Index

[1]The ratings issued by Nationally Recognized Statistical Rating Organizations assess the credit worthiness of a corporation's or government debt issues. The ratings apply to the fund's holdings and not the fund itself. The higher of the ratings between Moody's, Standard & Poor's, and Fitch is used. If one of the three agencies does not have a rating, the higher of the other two ratings is used. If only one agency has rated the bond, the rating from that agency is used. If none of the three agencies have rated the bond, the bond is placed in the Not Rated category.

RISK CONSIDERATIONS

Credit & Interest: Debt securities are subject to various risks, the most prominent of which are credit and interest rate risk. The issuer of a debt security may fail to make interest and/or principal payments. Values of debt securities may rise or fall in response to changes in interest rates, and this risk may be enhanced with longer-term maturities. **Bank Loans:** Loans may be unsecured or not fully collateralized, may be subject to restrictions on resale and/or trade infrequently on the secondary market. Loans can carry significant credit and call risk, can be difficult to value, and have longer settlement times than other investments, which can make loans relatively illiquid at times. **High Yield-High Risk Fixed Income Securities:** There is a greater level of credit risk and price volatility involved with high yield securities than investment grade securities. **Liquidity:** Certain securities may be difficult to sell at a time and price beneficial to the fund. **Leverage:** When a fund leverages its portfolio, the value of its shares may be more volatile and all other risks may be compounded. **Market Volatility:** Local, regional, or global events such as war, acts of terrorism, the spread of infectious illness or other public health issues, recessions, or other events could have a significant impact on the portfolio and its investments, including hampering the ability of the portfolio manager(s) to invest the portfolio's assets as intended.

FLOATING RATE COMPOSITE GIPS COMPOSITE REPORT

		Composite Assets		Annual Performance Results					
				Composite			Benchmark†		
Year End	Total Firm Assets (billions)	U.S. Dollars (millions)	Number of Accounts	Gross	3 Yr Ann Std Dev	Net	Return	3 Yr Ann Std Dev	Composite Dispersion
2019	10.6	545	Five or fewer	8.86%	3.00	8.32%	8.17%	2.63	N.A.
2018	10.4	601	Five or fewer	-0.05%	2.80	-0.55%	1.14%	2.75	N.A.
2017	12.0	713	Five or fewer	4.08%	2.54	3.56%	4.25%	2.63	N.A.
2016	11.7	692	Five or fewer	9.64%	2.69	8.99%	9.88%	2.78	N.A.
2015	11.4	695	Five or fewer	0.53%	2.30	-0.08%	-0.38%	2.07	N.A.
2014	12.6	871	Five or fewer	1.76%	2.23	1.15%	2.06%	1.92	N.A.
2013	12.3	1,042	Five or fewer	6.40%	3.91	5.77%	6.15%	3.51	N.A.
2012	10.8	467	Five or fewer	10.04%	4.57	9.39%	9.43%	4.07	N.A.
2011	8.1	391	Five or fewer	2.81%	6.68	2.19%	1.82%	7.52	N.A.
2010	*	240	Five or fewer	10.12%	na	9.46%	9.98%	na	N.A.

†Benchmark: Credit Suisse Leveraged Loan Index

Composite/Benchmark Standard Deviation: na - The three-year annualized ex-post standard deviation of the composite and/or benchmark is not presented because 36 monthly returns are not available.

Composite Dispersion: N.A. - Information is not statistically meaningful due to an insufficient number of portfolios in the composite for the entire year.

* Prior to June 2011, the Multi-Sector Fixed Income Team was part of Goodwin Capital Advisers, a Phoenix Company. Since management of the mutual funds prior to this date was under a sub-advisory agreement with Goodwin and the predecessor firm, the requirements for performance portability for inclusion in the composite have been met.

The Floating Rate Composite contains all fully discretionary, fee paying floating rate (bank loans) accounts. Emphasis is on investments in fixed income across multiple sectors of the fixed income market with the following restrictions: maximum below investment grade securities 100%, average credit quality is at least B and non-US exposure 0-5%. The strategy may invest up to 20% in high yield bonds. Leverage may be utilized to achieve the investment objective or to meet repurchase requests and for temporary, extraordinary or emergency purposes. The strategy seeks total return and income by investing in non-investment grade bank loans.

Effective January 28, 2019, the composite's benchmark is the Credit Suisse Leveraged Loan Index, replacing the previous benchmark, the S&P/LSTA Leveraged Loan Index. This benchmark change is retroactive since inception. The Credit Suisse Leveraged Loan Index is a market-weighted index that tracks the investable universe of the U.S. dollar denominated leveraged loans. It has been selected for the benchmark because it is more widely used within the industry and the manager believes that the new index provides investors with a better correlated statistical tool for investment analysis and research than the prior index. The index is unmanaged, its returns do not reflect any fees, expenses, or sales charges, and is not available for direct investment.

Newfleet Asset Management, LLC is a registered investment adviser and an indirect wholly owned subsidiary of Virtus Investment Partners. The minimum account size for this composite is $15 million. The Floating Rate Composite was created on April 1, 2012. Results are based on fully discretionary accounts under management, including those accounts no longer with the firm. Past performance is not indicative of future results. The U.S. Dollar is the currency used to express performance. The annual composite dispersion is an asset-weighted standard deviation calculated for the accounts in the composite the entire year. Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request.

Returns are presented gross and net of management fees and include the reinvestment of all income. Effective 2/1/2017, net of fee performance was calculated using 1/12 of the highest fee of 0.50% (prior to 2/1/2017 the highest fee was 0.60%), applied monthly, and includes performance based fees. Actual investment advisory fees incurred by clients may vary. The management fee schedule is as follows: First $100 million – 0.45%, over $100 million – 0.40%. Newfleet Asset Management, LLC claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Newfleet Asset Management, LLC has been independently verified for the period January 1, 1990 through December 31, 2019.

Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. The Floating Rate composite has been examined for the periods June 2, 2011 through December 31, 2019. The verification and performance examination reports are available upon request. The firm maintains a complete list and description of composites, which is available upon request.

For more information on the Newfleet Fixed Income strategies, please contact:

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