

FULL DISCRETION

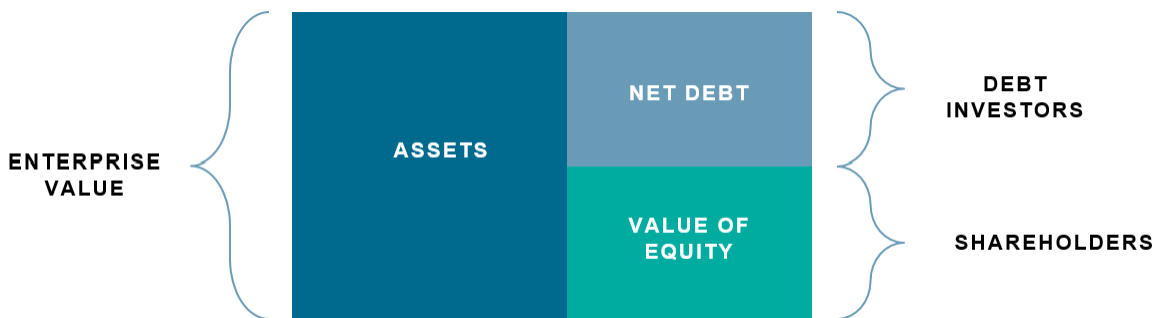
Extra Credit

‘EV’ is the Future, and We Don’t Mean Electric Vehicles

When it comes to portfolio construction, the Full Discretion team has long employed a combination of bottom-up security selection and top-down, macroeconomic analysis. We utilize a credit cycle framework to evaluate the factors driving the cycle, anticipate broad sector mispricings and seek to take advantage of changes in risk premium at every stage. This process helps us identify the risk drivers we want to emphasize, or seek to avoid, in our portfolios and lays the foundation for our overall risk assessment at the issuer level. Enterprise value is the anchor by which we conduct our bottom-up fundamental analysis.

What is Enterprise Value and Why is it Important?

We define the enterprise value of a business as the discounted value of the company’s future cash flows. Enterprise value less net debt equals the intrinsic value of the business’ equity.



We believe that equity value and probability of default are directly related. Defaults can occur when the value of the equity underneath the debt no longer sufficiently entices lenders to contribute new money for refinancing upcoming maturities and/or funding cash burn. By maintaining a view on the enterprise value, and thus the equity value, we can measure, evaluate and project the probability of defaults increasing or decreasing.

How Does the Full Discretion Team Use Enterprise Value?

Every credit discussion starts with the question: “what is this business worth?” This simple question sparks our process for evaluating the factors that can drive the value of a business and how they could change over time. We believe that when the equity value is increasing, the margin of safety, or “cushion”, under the debt is expanding. This is when we would expect the probability of default to decline and bond spreads to tighten. Conversely, when the value of the equity is declining, the cushion



under the bonds is decreasing, which causes the probability of default to increase and bond spreads to widen. This framework helps us to identify investment opportunities that we believe will trade well through their current credit ratings. Because rating agencies tend to be backward looking, there are often mispricings that can be exploited. We can also recognize value traps, which are businesses with eroding equity cushions due to their acceptable, but declining, credit statistics.

Additionally, by focusing on enterprise value, we can find opportunities throughout the entire capital structure. As an example, our research team previously analyzed a telecommunications company that had secured investment grade debt, unsecured high yield debt, a mandatory convertible and equity. We had initially examined this company in more detail as we believed it to be an upgrade candidate, which is one of the six security selection pillars utilized by the team in building portfolios. Through our enterprise value analysis, we concluded that, in our opinion, the unsecured debt was attractive and it would be upgraded to investment grade at a faster pace than the market was indicating. We also determined that the equity appeared to be undervalued, so we bought the convertible and equity, where possible, in order to capitalize on the perceived opportunity.

Enterprise value also plays a role in our sell discipline. If we lose conviction in the enterprise value of a business, we will look to decrease our position or sell out of the credit. This is particularly true if we believe the reduced visibility in the business' cash flows, and resulting enterprise value, are not reflected in the value of the investment.

The Full Discretion team brings an equity-like approach to research with a focus on discovering mispriced securities. We take a long-term investment view, looking through the credit cycle for opportunities where we believe the potential for credit improvement exists. Enterprise value gives us the conviction to take advantage of opportunities that can be overlooked by the market. We seek to understand what the underlying business is worth as a critical component of our overall security selection process.

Please see Important Disclosure on following page, an integral part of this document.



Meet the Team



Matt Egan, CFA
Head of Full Discretion, Portfolio
Manager



Brian Kennedy
Portfolio Manager



Todd Vandam, CFA
Portfolio Manager



David Zielinski, CFA
Investment Director



Cheryl Stober
Investment Director



Kristen Doyle
Associate Investment Director

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