Bahl&Gaynor
Investment Counsel

January 2016

Interim Update

following our 2016 Economic Update "Schizophrenic Squirrel"

In this issue:

It's What You Owe

It's not what you own that kills you... it's what you owe

Warning: This is not your cookie-cutter advisor letter. During periods of market stress, there is the clockwork mailing of generic and uninspired advisor letters. These cookie-cutter notes tend to be chock full of "hope" and a universal message to "buy the beaten up stocks". The Taylor Swift and crafts station is in another room.

Thesis: It is our view that the blanket "buy the dip" strategy that has worked so well over the past six years is now compromised. The day of reckoning for levered balance sheets is upon us and having an acute eye towards credit will prove critical for investing success and avoiding permanent losses of principal (PLOPs). As the market navigates what will be a painful deleveraging cycle, the core of any investment portfolio must be well capitalized companies with established competitive moats and proven access to capital.

Source: www.cagle.com

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It's What You Owe *Continued*

Over the past two decades, we've experienced firsthand a few significant booms and busts within the credit markets. During each boom, it felt as if the trend had real permanence and extrapolations were sent to epic proportions. And, the violent unwind of each of those booms was stronger and longer than anyone had thought. Glory. Greed. Fear.

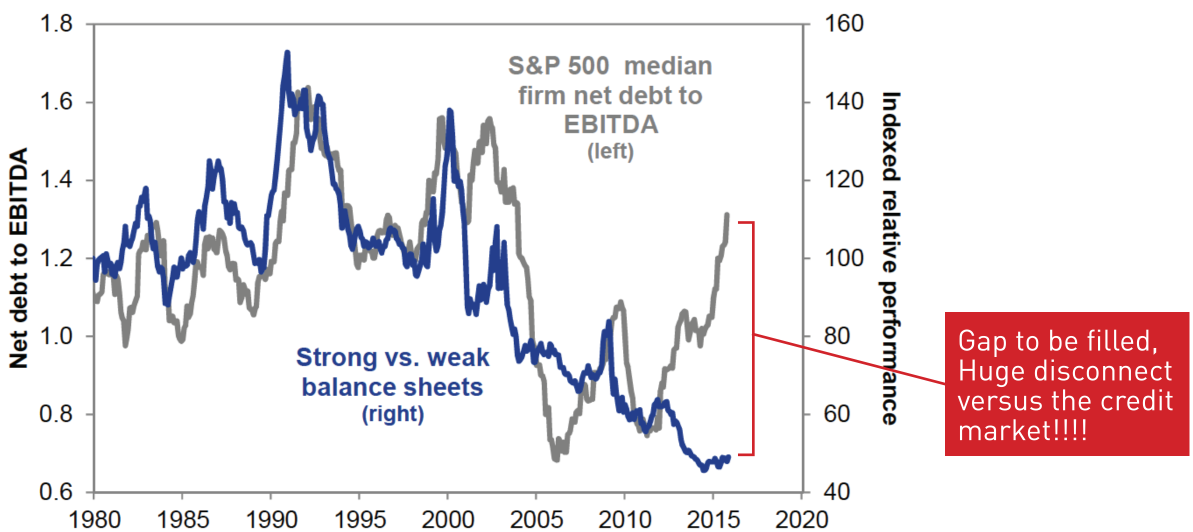
For example, the LBO boom in 2006/2007 spawned financiers to model buyouts north of $100bn. Home Depot(!) was one of many rumored targets at the peak of the frenzy. The LBO boom and credit market fears spawned a derivative market whose trading would dwarf that of the underlying securities. Structured credit became mainstream and capital swarmed to these newly created "AAA securities."

In hindsight, the mega-LBO cycle busted spectacularly and the derivatives associated created their own massive unintended negative consequences. However, at the time, fears of an over-extended M&A and credit market were chalked up as "this time it was different". Famous last words. The violent unwind of this strategy left Bear Stearns, Lehman Brothers and the financial industry as we once knew it in tatters. Only now, eight years later, does the banking system appear to fully have its legs underneath it.

Moving forward to today, the investment buzzword of the 2010s has been the "efficient frontier". In its simplest format, the thesis is that a portfolio is constructed with seemingly less correlated assets to produce a maximum return relative to the portfolio's projected volatility.

The concept of "efficient frontier" has percolated into the executive suite as CEO's have been searching for the most efficient capital structure. Aided not so subtly by activists, the answer has universally been "more leverage" with a focused sweet spot on BBB/BB. Historically, there has been a clear correlation between well-capitalized companies outperforming their weaker counterparts during periods of rising corporate leverage. However, that relationship has not held since 2011 as the market has rewarded higher leverage (indicated in the exhibit below). As a result of the positive feedback loop, debt on corporate balance sheets is now at levels not seen since the financial crisis.

Historically low rates encouraged firms to lever without penalty (as of December 10, 2015)



Source: Goldman Sachs Global Investment Research, 2015.

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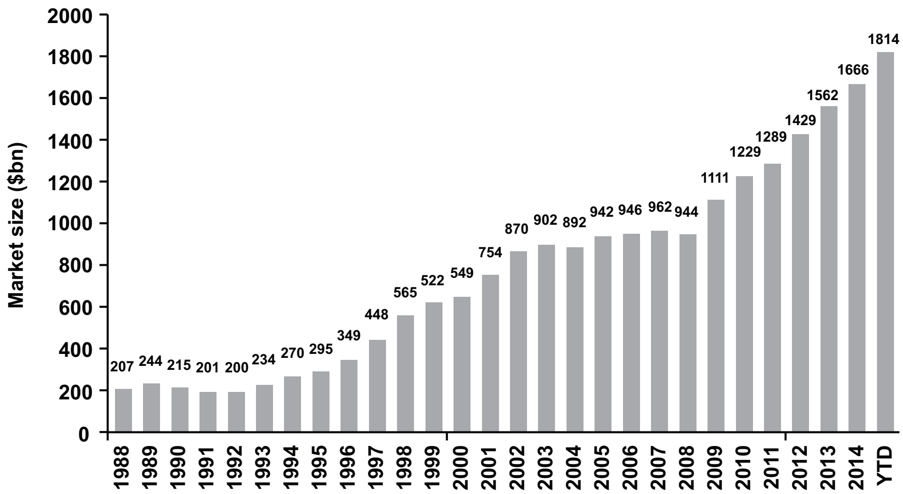
It's What You Owe *Continued*

High-yield market growth



Source: J.P. Morgan.

Chasing positive and "less correlated" returns, the growing high yield investor base was more than willing to accommodate the debt required for these newly "optimized" capital structures (without covenants, no less!). Since 2008, the high yield market has expanded from $944bn to $1.8trn, representing a near 100% increase.

The positive feedback loop was furious. Nearly every purchase of high yield since 2008 has been a good one with six consecutive years of positive returns until cracks emerged in 2H15. Performance chasing and a historically strong credit cycle caused a rush of money into the oxymoronic "high quality junk bond" strategies.

The majority of the new money can be classified as "tourists" aka renters, not owners. As a class, these tourists are unfamiliar with the risks and illiquidity and only familiar with a recent history of strong returns. Similar to the cracks that emerged in late 2007 in the mortgage market, cracks emerged over the past six months in levered credit. Faced with the prospect of deep and sustaining outflows, we've heard numerous times how the high yield capital markets have "evolved" and are better equipped to withstand financial shocks. In summary, we've again been told "this time it's different."

It is our view that the problems we are witnessing with deep cyclical and commodity-related firms are not simply a matter of a flawed business model, but more of a flawed capital structure thesis. **It's not the assets that these firms own that is causing widespread losses; it's the debt they owe which is suffocating their firms.**

Similar to how the M&A had its violent unintended negative consequences, the "efficient capital structure thesis" is currently in the process of unwinding. Prior capital provided to many firms is likely permanently impaired. Further access to capital will prove to be prohibitively expensive for current equity holders. A blanket "buy the dip" mentality for the beaten-up names will potentially compound losses. Without taking capital structure into full consideration within an investment thesis will prove to be a perilous exercise. To reiterate, the game-plan has changed.

At Bahl & Gaynor, we are taking an extremely proactive approach as we discussed a few weeks ago in our 2016 Outlook, "Schizophrenic Squirrel". **We continue to aggressively emphasize the view of moving further up-in-quality via owning well-capitalized companies with established moats and proven access to capital.**

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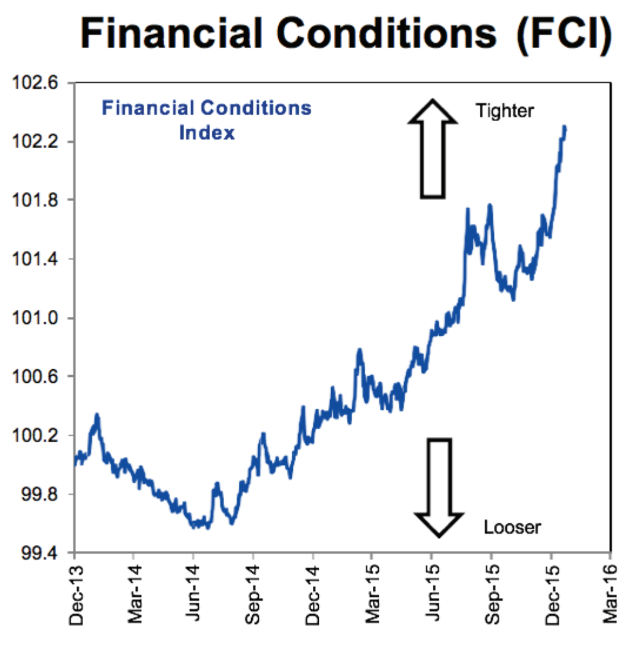
Debt – Explained & Applied Case Studies

In its most basic form, debt is consumption pulled forward. So long as assets are rising in value and the world is viewed through an Excel spreadsheet, the most efficient capital structure is one that is more levered. However, when economic cycles are experienced, there are periods where asset prices go down… swiftly and significantly.

Debt has to be repaid. Whether the debt is paid down or rolled over, levered corporations are in constant need of hospitable capital markets. In times of financial stress, only the least levered and least risky business models have ready access to capital. Financial conditions currently are materially worse than any other period since the Financial Crisis. Not only are financial conditions in stress, they have been steadily trending higher since June of 2014. Said differently, the trend is not your friend if you are captive to the capital markets.

Exhibit: Financial Conditions Are Tighter Than At Any Time Since the Financial Crisis



Source: Goldman Sachs Global Investment Research

Credit Ratings do not define High Yield; a "High Yield" defines High Yield.

With the boom in high yield, so followed has been the boom in BB-rated debt strategies. These Core+ portfolios have been popular considering the historically low default rate on debt with that rating relative to the yield received. It's no coincidence that the popularity of these strategies perfectly coincided with the optimal capital structure thesis. However, there are real cracks in that thesis. For example, many mining companies are still investment grade. Freeport-McMoran (FCX), a highly levered mining firm, has seen the market value of its debt drop nearly 60% as the price of copper has been decimated (chart below). Despite this, FCX still remains Baa3/BBB- at Moody's and S&P, respectively. History rhymes again with the rating agencies?!?!

For companies in distress, the debt is now the equity. Considering FCX, with its debt in the mid-40s and a 17% yield, the market is demanding equity-like return for owning the debt. Therefore, FCX's roughly $4.5bn equity market value is an option on survival and copper prices, effectively a warrant. Owning these "warrant-like" securities is only for the bold and those able to withstand material volatility. **<u>There are old pilots and bold pilots, but no old, bold pilots.</u>**

FCX is just one example. Despite being "investment grade," the company currently has zero access to the traditional capital markets. Using credit ratings alone and not respecting access to capital is a recipe for critical errors and permanent losses.

Exhibit: Freeport-McMoran 2024 Debt: $44, 17%, But Still Investment Grade!?!?!?

Source: Bloomberg

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Debt *Continued*

Debt Is a Competitive Handcuff.

Let us consider the competitive landscape in the telecommunications market. There are four major carriers: Verizon, AT&T, T-Mobile and Sprint. As the quality of the network has improved, wireless service has become increasingly viewed as a commodity. By definition, a commodity has near-zero pricing power. So, for most customers, the choice between the four carriers simply comes down to price.

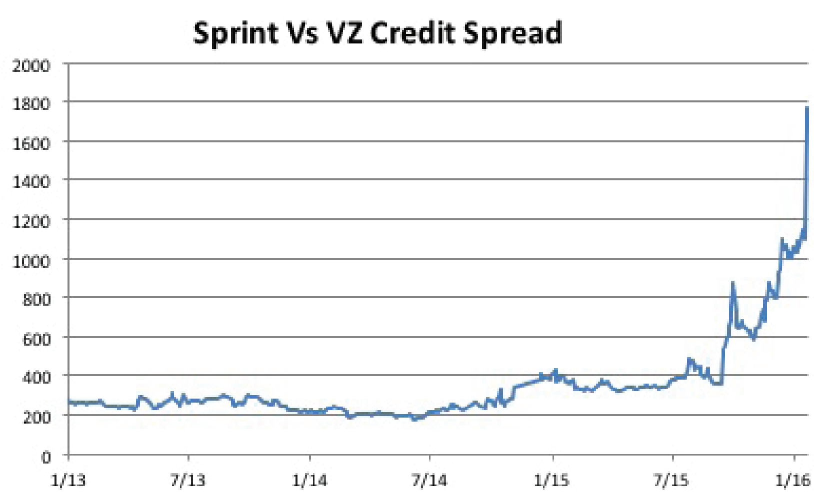
With a very capital-intensive business, all four firms relied heavily on the debt capital markets to finance their networks. On a relative basis, Verizon and AT&T have materially more conservative capital structures versus Sprint. Over the most recent investment cycle, the higher financing cost was not an issue as the cost of Sprint's debt versus the leading carriers was only 3% higher. However, that difference has exploded over the past four months as investors have worried about Sprint's viability with its hemorrhaging cash flow. These worries have become a self-fulfilling prophesy as the financing spread has exploded to nearly 20%!

At a 15-20% financing cost differential, Sprint faces the following options:

1. Charge more for it services.
2. Redirect capital from network improvement to debt pay-down.
3. Cease to exist as a stand-alone entity.

Given that we have a commodity-like business, Sprint cannot charge more. Moreover, "kicking the can" on capital expenditures will guarantee an inferior product and accelerate subscriber losses. In effect, the debt market is holding Sprint hostage. **"Hostage" is not a term one wants associated with his or her holdings.**

Exhibit: Sprint Held Hostage By Capital Markets



Source: Bloomberg

The Bottom Line

While history does not repeat, it certainly rhymes. This time it is not different. Corporations that have depended on the depth of the capital markets for their expansion are firmly in the crosshairs. As opposed to the past six years, a "V-shaped" recovery in credit spreads is not coming. Similar to the unwind of prior credit booms, this deleveraging cycle will be longer and deeper than market expectations. With a contracting credit market, further access to capital will be at progressively more punitive terms.

In conclusion, Bahl & Gaynor views that any investment thesis will require strong backbone of credit analysis and view on capital market access. Therefore, the core of any investment portfolio must be well capitalized companies with established competitive moats and proven access to capital.

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Thanks

Your continued support and interest is much appreciated.

Everyone at Bahl & Gaynor would like to thank you for the opportunity to serve your investment needs. Please feel free to contact any member of the Institutional Client Service Team through the information provided below if you have questions.

Sincerely,

Bahl&Gaynor
Investment Counsel

Important Disclosures

Legal Stuff