PIA HIGH YIELD FUND

INVESTMENT COMMENTARY & REVIEW

by Bob Sydow, Kevin Buckle and Jim Lisko

Third Quarter 2015

While energy related credits have been the primary under-performers over the past year, price declines spread throughout the broader high yield market in the third quarter ending Spetmeber 30, 2015, with virtually all industry sectors in negative territory. The Barclays High Yield Index produced its worst quarterly performance in four years (-4.85%), reflecting a sizeable quarterly spread increase of 158bps from 514bps to 672bps. The high yield market has not seen credit spreads this wide since June of 2012, and now sits 310bps wide of its post-recovery low of 362bps reached in June of last year. High yield average prices have dropped 12.8% since June 2014, while the S&P500 is only down 2% over the same period. Credit quality mattered during the third quarter, as CCC rated credits fared worst returning -7.29%, while B's and BB's returned -5.62% and -3.10%, respectively. A series of events affected investor mindsets during the quarter including; continued weak commodity pricing and demand, slowing global growth, and an ongoing anxiety over interest rates. The big picture question remains; is this just another hiccup in the high yield market, or a market adjustment to perceived looming credit deterioration? We believe the market has been oversold, and while there are underlying trends to watch, the current high yield spread levels are more than compensating for the near-term risks.

A year ago (3Q'2014) we cautioned about the risks in the energy sector (15.6% of the Barclays High Yield Index at its peak and second largest industry within the Index). Up until this quarter, much of the oil price impact on the high yield market was self-contained within the volatile high yield energy and commodity credit universe. Year-to-date through June, energy was actually one of the better performing high yield sectors, as independent and oil service credits retraced some of their earlier steep 4Q'2014 losses. However, the energy sector declined 15.9% in the third quarter, exacerbated by defaults and further erosion in oil prices. Unlike 4Q'2014 when the energy sector declined 10.6% while the rest of the market managed to still earn its coupon (roughly +.47%), the third quarter saw the market ex-energy decline -3.28%. Other industries such as chemicals, paper, metals/mining, and telecom were particularly hard hit. So while energy was a contributor to the weakness, it was no longer the sole outlier. Energy risk remains a concern within the market, but we think most of that is already priced in. Energy now comprises 12.5% of the Index, down from its peak of 15.6%. More granularly, virtually the entire energy sector decline is due to the more vulnerable energy independents sub-index (Exploration & Production), which has now fallen from 8.7% to 6.0% of the Index. In September 2014, the average bond price of the independent sub-index was 100.9, and today it is 69.1; while the average high yield bond price is 92.6. While we expect the overall energy index concentration to decrease more over the next 12 months largely driven by defaults, we think the energy sector will become less of a negative drag on high yield performance going forward.

While energy remains in the headlines, there are other looming warning signs to watch such as increasing Mergers & Acquisitions (M&A) and alarmingly high levels of distressed bonds. These are justifiably associated with deteriorating credit conditions.

We have previously referenced the potential for increased M&A activity in the market, especially given the slowing earnings growth rates of corporate America and very low interest rates. Refinancings have generally dominated high yield new issuance post-crisis through 2014, ranging between 54% and 65% of domestic issuance. M&A issuance, over the same time period, has ranged from a low of 5% in 2009 to 26% in 2014. However, year-to-date we have reached a post-crisis high in M&A new issuance of 40%. In September, where a relatively modest $21B was issued in the U.S., M&A related financing constituted an abnormally high 70% of new issuance – largely dominated by two large telecom companies. The last time the high yield market saw acquisition issuance at or above these levels was during 2006-2008. Despite the increasing M&A issuance, it should be noted that CCC issuance was only 2.8% in the third quarter, and 5.6% year-to-date, which is the lowest annual level since 2010. To this point, this

increased M&A activity has not resulted in deteriorating new issue credit conditions.

Similar to M&A issuance, the amount of distressed bonds (those trading below 50% of par) is at levels not seen since the great recession. This, however, is predominately skewed by what is happening in the energy and commodities sectors. In fact, approximately 82% of the distressed universe is comprised of issuers in these sectors. Adjusting for this, the balance of the market shows no abnormal signs of distress.

Overall, we believe the current high yield spreads are overcompensating investors for the current risks in the market. Indeed with spreads of 670bps, investors are now factoring in a default rate approaching 7%. That is almost double what most market prognosticators expect, and a default rate more associated with a modest recession. The current LTM par-weighted default rate is 2.29% (Source: JPMorgan). JP Morgan is forecasting a default rate of 3.0% in 2016, which includes an energy sector default rate of 10%. In fact, excluding energy, JP Morgan is forecasting a very modest 1.5% default rate next year. We believe that energy may drive defaults slightly higher than the JP Morgan forecast, but not close to the default levels already priced into the market.

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Barclays High Yield Index - covers the universe of fixed rate, non-investment grade debt. Eurobonds and debt issues from countries designated as emerging markets (e.g., Argentina, Brazil, Venezuela, etc.) are excluded, but Canadian and global bonds (SEC registered) of issuers in non-EMG countries are included. Original issue zeroes, step-up coupon structures, 144-As and pay-in-kind bonds (PIKs, as of October 1, 2009) are also included. The index includes both corporate and non-corporate sectors. The corporate sectors are Industrial, Utility, and Finance, which include both U.S. and non-U.S. corporations. The Yankee sector has been discontinued as of 7/1/00. The bonds in the former Yankee sector have not been removed from the index, but have been reclassified into other sectors.

Basis point (bp)- A unit that is equal to 1/100th of 1%, and is used to denote the change in a financial instrument.

Spread - The difference between yields on differing debt instruments, calculated by deducting the yield of one instrument from another.

S&P 500 Index – The S&P 500 index includes 500 leading companies in leading industries of the U.S. economy. The S&P 500 is designed to be a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of the large cap universe. You can not invest directly in an index.

Bond ratings provide the probability of an issuer defaulting based on the analysis of the issuer's financial condition and profit potential. Bond rating services are provided by Standard & Poor's, Moody's Investors Service, and Fitch Investors Service. Bond ratings start at AAA (denoting the highest investment quality) and usually end at D. (meaning payment is in default) In limited situations when the rating agency has not issued a formal rating, the Advisor will classify the security as nonrated.

Yield - This refers to the interest or dividends received from a security and is usually expressed annually as a percentage based on the investment's cost, its current market value or its face value.

Default - The failure to promptly pay interest or principal when due.

Default Rate - The rate of borrowers who fail to remain current on their loans. It is a critical piece of information used by lenders to determine their risk exposure and economists to evaluate the health of the overall economy.

New Issue - A reference to a security that has been registered, issued and is being sold on a market to the public for the first time.

LTM - Last Twelve Months. A period of time commonly used to evaluate financial results such as a company's performance or investment returns.

Earnings growth is not representative of the fund's future performance.

Opinions expressed are subject to change, are not intended to be a forecast of future events, a guarantee of future results, nor investment advice.

Past performance does not guarantee future results.

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