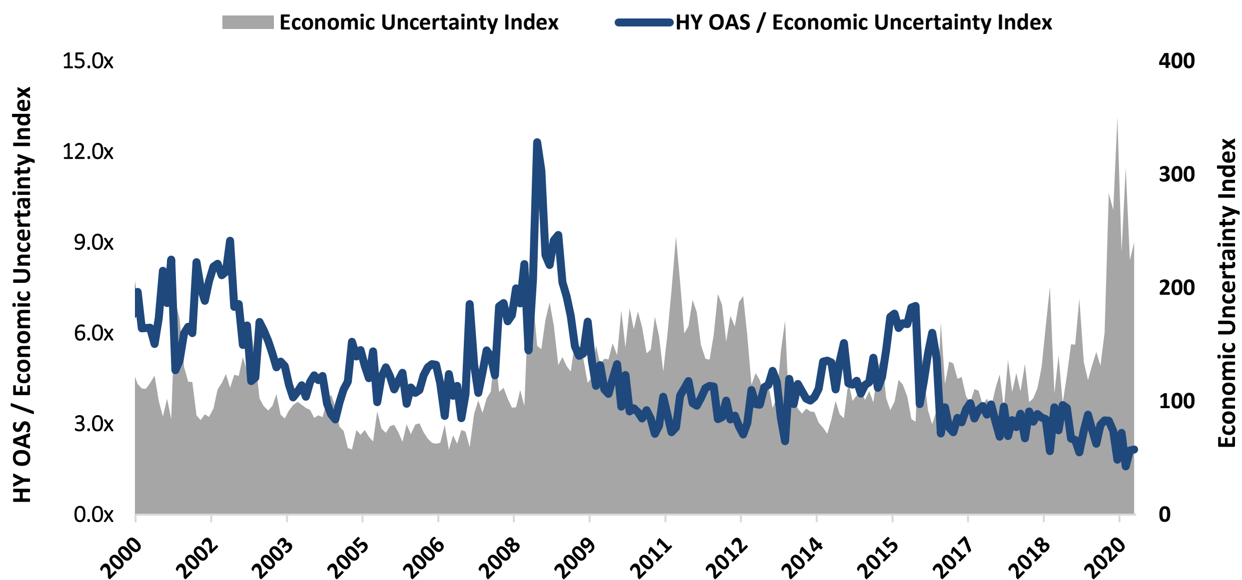
3Q 2020 Commentary - The Iceberg Phenomenon [1]

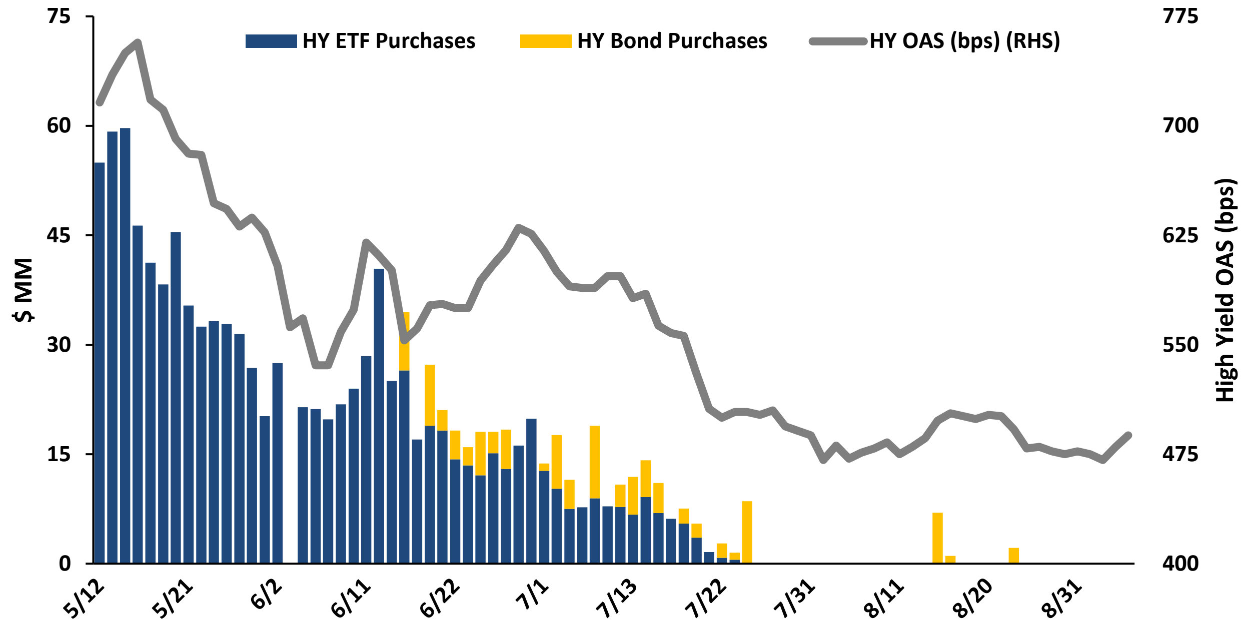
Scientifically, 10% of an iceberg is visible while 90% of its volume is unseen, below the water's surface. In the U.S. equity and fixed income markets, the dramatic rebound from the March trough brought this to mind as there is a lot more going on below the surface. We don't know how long or how much further the broad market will continue to rally, but we are confident that many individual corporate credits will diverge from the market. As bottom-up investors, the tip of the iceberg phenomenon creates opportunity for us.

High Yield Credit Spreads and Economic Uncertainty Index (EUI) [2]



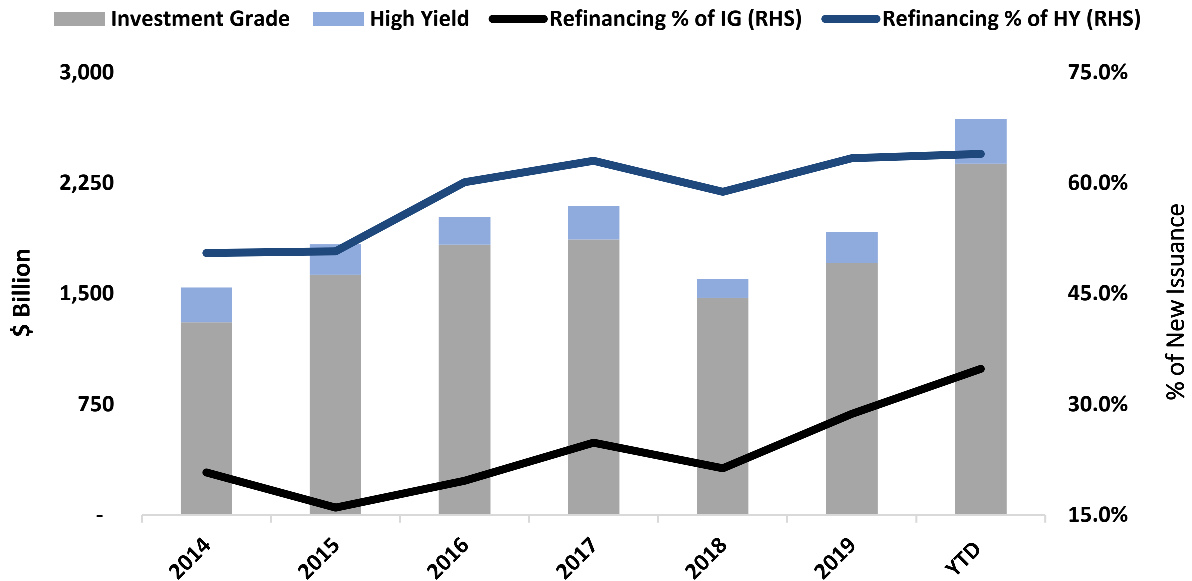
Economic uncertainty as measured by the EUI cited above is at its highest level in 20 years. However, the high yield spread to Treasury relative to the EUI is at the lowest level in 20 years. Effectively, the "junk bond" credit spread divided by the EUI is paying you 2.2 basis points for every unit of uncertainty in comparison to its peak of 12.3 basis points in November 2008. It appears that "Mr. Market" believes that the economic recovery will continue to be robust[3], or macro and structural concerns are overstated. Should Mr. Market be wrong, one is not being compensated for "tail risk".[4]

Secondary Market Corporate Credit Facility (SMCCF) 2020 HY ETF and Bond Purchases vs HY Option Adjusted Spreads [5]



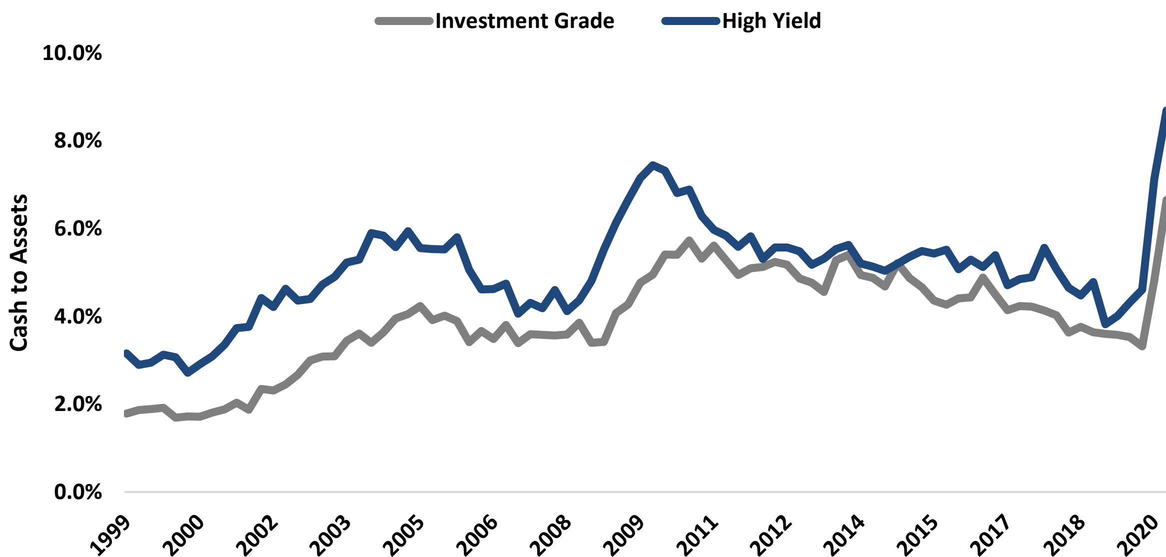
On March 23, 2020, the Federal Reserve established the Secondary Market Corporate Credit Facility (SMCCF) to support the capital markets in the face of the economic shut-down brought on by the COVID-19 pandemic. SMCCF purchases began in mid-May[6] and, by the end of June, it owned approximately 2% of the largest high yield bond ETFs and over 4% of the largest investment grade bond ETF[7,8]. This was very effective[9] in calming the markets and establishing investor confidence that the "Fed put"[10] had been institutionalized. In aggregate, SMCCF purchases have totaled approximately $13 billion, far short of its $250 billion purchasing capacity, leaving a large portion of "dry powder" for the future.

Investment Grade and High Yield New Issuance [11]



As a result of the Fed's support, the corporate bond market has been "on fire;" issuance has risen to an all-time high with total new issuance exceeding the previous annual record after only nine months. Issuer motivations range from shoring up liquidity to taking advantage of historic low interest rates. This has been particularly beneficial to the CrossingBridge Low Duration High Yield Fund as it has provided an abundance of opportunities to invest in high yield bonds and "fallen angels"[12] that are being called or redeemed.

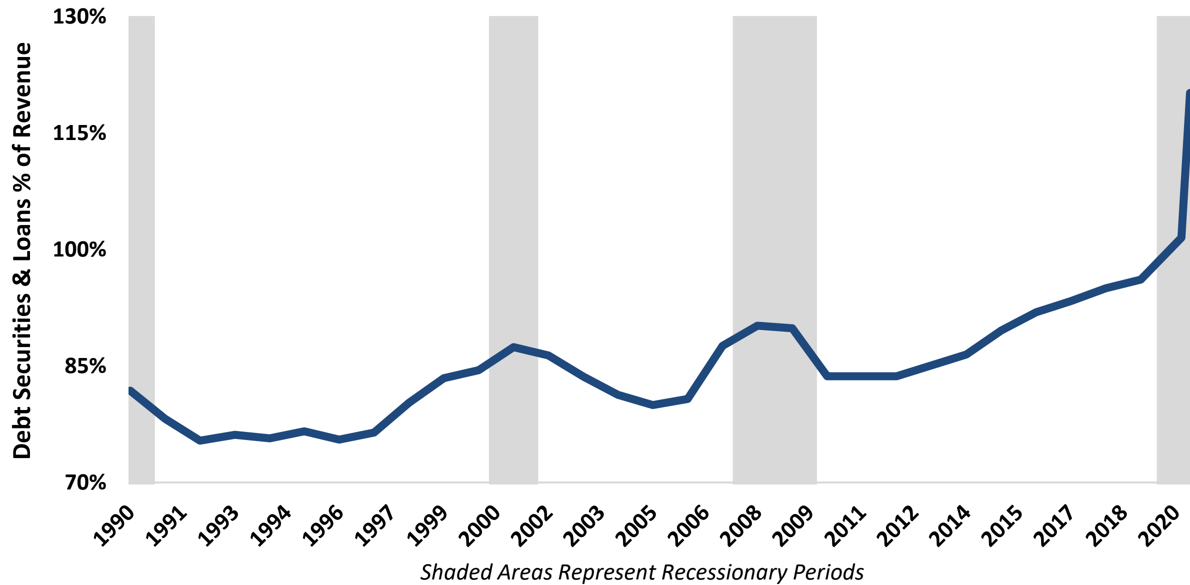
Cash to Assets [13]



As shown above, cash as a percentage of corporate balance sheets has risen to a 20-year high for both investment grade and high yield issuers. As previously mentioned, contributing factors

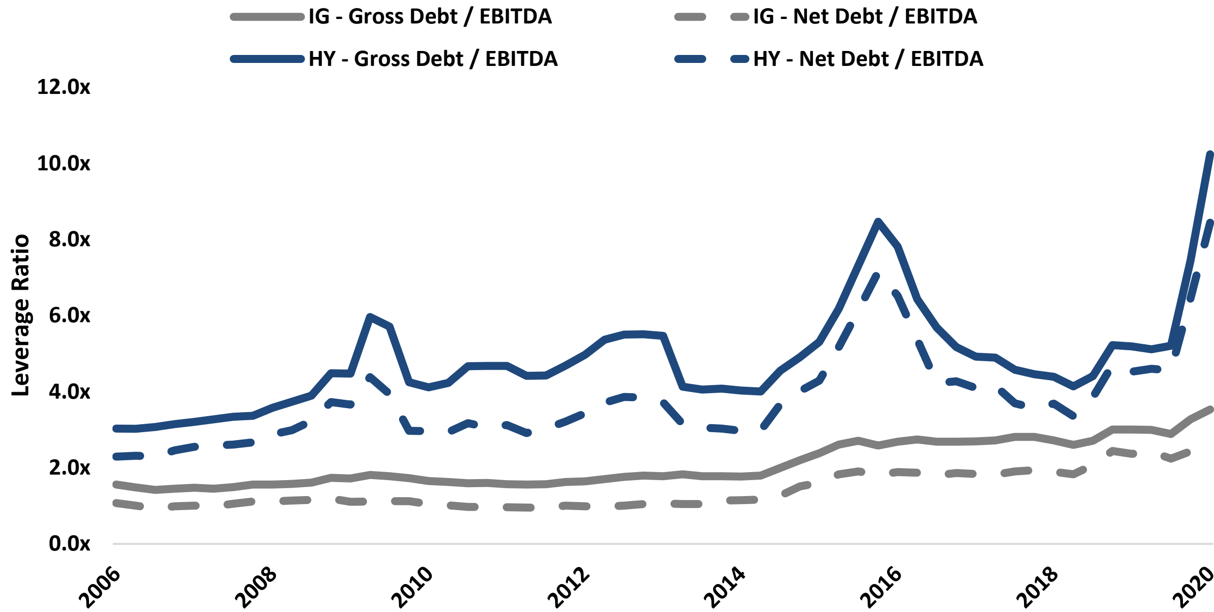
include expense reductions, inventory liquidations and cash raised via the capital markets to supplement liquidity or cover operating expenses.

Non-Financial Corporate Businesses Debt Securities & Loans as a % of Revenue [14]



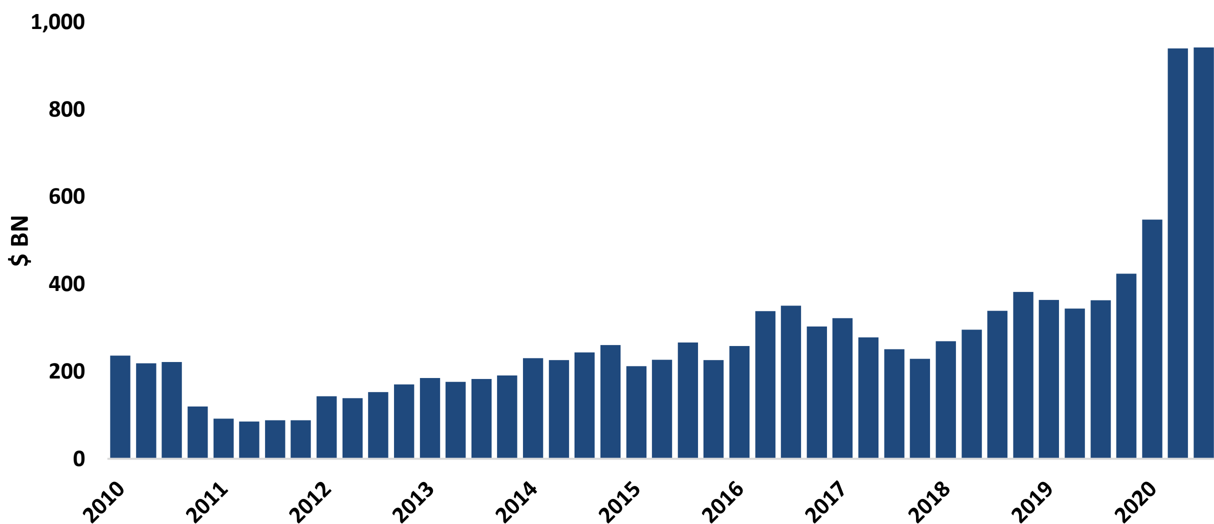
Much of the cash now sitting on corporate balance sheets or used to meet companies' cash burn was raised through new debt issuance. As of September 30, corporate debt as a percentage of trailing revenue has risen sharply to 120%. The Fed's programs were successful in preserving access to the capital markets for most corporations.[15] But…

Investment Grade and High Yield Leverage Ratios [16]



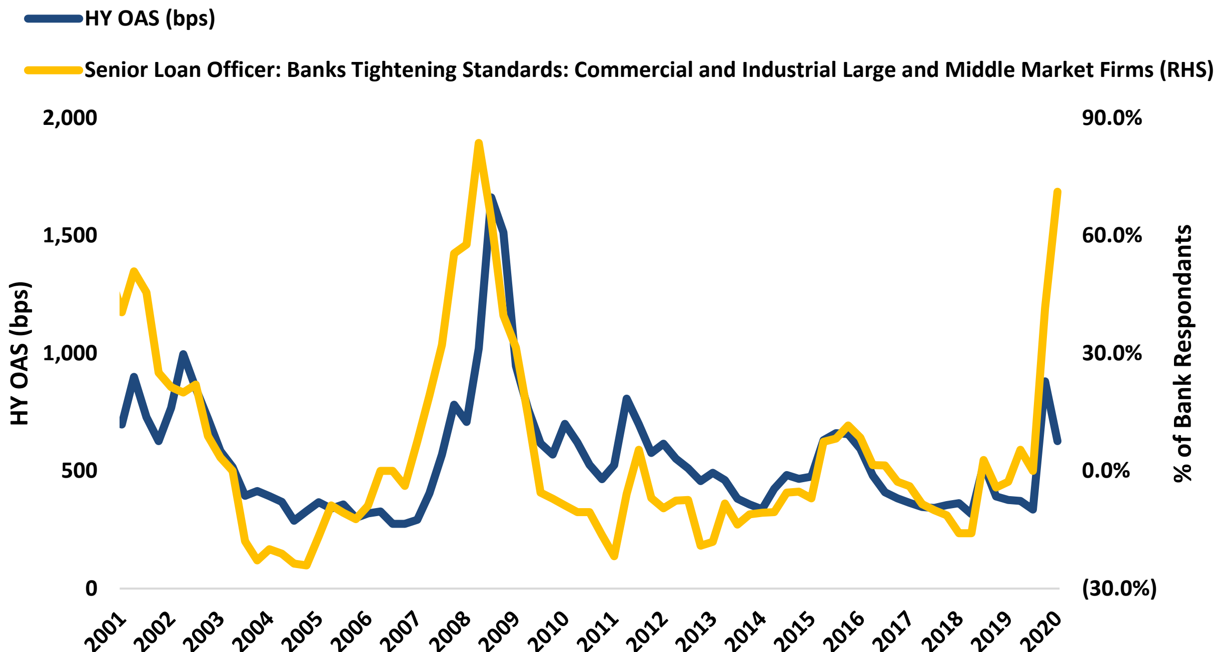
More importantly, the rise in debt issuance and the decline in cash flow due to the pandemic has caused an increase in leverage for both investment grade and high yield credits to levels not seen in at least 15 years. Even netting out cash on corporate balance sheets, leverage is elevated. For some, increasing leverage was a matter of survival or for others it was "just in case we need the money." As the economy returns to the "new, new normal," some companies will use the excess cash to repay the debt incurred and the increase in leverage will prove to be temporary. For others, who needed cash literally to keep the lights on while revenues dwindled, this heightened level of leverage may become virtually permanent, potentially creating a new cohort of "zombie"[17] companies that are barely able to cover their interest expense, but are unable to repay debt.

BBB and BBB- Debt on Negative Outlook [18]



After an initial surge in credit downgrades and "fallen angels" in 2Q20, further credit rating deterioration has moderated. As illustrated above, however, the amount of debt rated BBB and BBB- that is on "Negative Outlook" for potential downgrade at the end of 3Q20 is at historic highs at over $940 billion, over 4 times both the mean and the median for the last 10 years. Further downgrades and defaults are lurking.

Senior Loan Officer Survey of Lending Standards vs. HY Spreads [19]



The Senior Loan Officer Survey of Lending Standards, conducted by the Federal Reserve, reflects the availability of loans for large and middle market firms. Historically, the movement of high yield credit spreads have corresponded with credit availability by traditional banks – narrower when credit is widely available, wider when loan officers perceive greater risk. Similar to the disconnect between high yield credit spreads and the level of economic uncertainty, there is also a disconnect between the willingness of commercial and industrial bankers to lend and that of buy-side debt investors (as illustrated by the decline in high yield credit spreads).[20] The Fed deserves credit for energizing the corporate bond market, driving down credit spreads at a critical juncture, but the tight lending standards reflected in the Senior Loan Officer Survey suggest that spreads are likely to rise.

Clearly, we believe today's landscape favors the "bottom-up" investor. Further, we see an increasing divergence between the "haves" and "have nots", those companies that have easy access to the capital markets and those that don't. Consequently, the broad fixed income markets will remain reflective of the herd mentality, but we believe that the economic volatility brought on by the pandemic is creating a large opportunity set that will reward investors willing to "roll up their sleeves."

Below we provide several examples of 3Q20 investments illustrating this point:

- Golden Nugget (NUGGET) – *Rescue financing that becomes event-driven opportunity*
- Martin Midstream Partners (MMLP) – *Out-of-court restructuring transitioning to mainstream high yield bond*
- MPC Container Ships (MPCCME) – *Activism to protect and create value*

Golden Nugget (NUGGET)[21] - Golden Nugget is a hospitality company that owns various casinos in Las Vegas, Atlantic City and Lake Charles, LA, restaurant chains Mastro's and Del Frisco's and iGaming, an online gaming business. iGaming has been growing at an annual rate of 48% since 2016 and is seeing significantly higher growth of late, likely due to stay-at-home requirements of the pandemic. After closing all of its properties in March, Golden Nugget projected $500 million of annual cash burn. With trailing net leverage of 6.3x and liquidity of $171 million, the company only had enough capital to support it for four months, with bankruptcy a realistic possibility. In April 2020, the company took advantage of its "cov-lite" credit agreement to issue a $300 million 3-year term loan, secured by the iGaming assets, at a 14.5% yield-to-maturity. This bridge financing increased the company's cash balance to over $550 million to extend its "runway". In addition to being secured by the iGaming business, the loan is effectively secured by the other Golden Nugget assets on a pari passu basis with Golden Nugget's existing secured term loan. We participated in the original issuance of this loan. In July, the company announced that iGaming would be sold to Lancadia Acquisition Corp., a SPAC partially sponsored by Golden Nugget's controlling shareholder. This de-leveraging event, through which Golden Nugget would become a public company, as well as its continuing cash flow growth, created a much-improved credit profile. Thus, we were comfortable purchasing the loan at a yield-to-worst in excess of 7.90%.

Martin Midstream Partners (MMLP)[22] - Martin Midstream Partners is a publicly traded master limited partnership that operates in four key business segments: storage, sulfur, transportation and natural gas liquids. It provides specialty services to major and independent oil and gas companies including refineries, chemical companies, etc. with significant business concentrated around the U.S. Gulf Coast refinery complex. Although MMLP is asset rich and diversified, the market tarred the company with the same brush as the energy industry and drove the company's $400 million of 7.25% senior unsecured bonds, due 2021, from 95 in mid-February to the upper 30s in late April. With relatively stable operating performance, low maintenance capital expenditures and leverage below 5x at year-end 2019, the company, under normal circumstances, would have expected to easily refinance the bond before its maturity in February 2021. However, with the loss of access to the capital markets, the company pre-emptively initiated an exchange offer. Entering a Restructuring Support Agreement on June 26, 2020, the company initiated the exchange on July 9 with the support of holders of 74.3% of the bonds. Per the exchange offer, the company proposed to exchange up to 100% of the bonds for an equal amount of new 11.50% second lien notes due 2025. As added incentive to participate, those electing to exchange would be permitted to purchase their pro rata portion of $50 million of newly issued 10% 1.5 Lien secured notes due 2024, of which much of the proceeds would be used to retire participating parties' old notes at par. In the resulting transaction, bondholders exchanged 91.76% of the old notes. This turned out to be a win-win for all parties. Holders who exchanged the old 7.25% note, received a new bond with a higher coupon and good collateral as well the opportunity to participate in an attractive new-money bond.

Holdouts that did not exchange their bonds saw the market price rise to 95 at September 30 and now have much greater confidence of repayment at maturity. The company avoided a bankruptcy that likely would have been costly, time-consuming and highly detrimental to all parties. In 3Q20, the CrossingBridge Low Duration High Yield Fund purchased the old 7.25% bonds and the 10% 1.5 Lien secured notes. At quarter-end, the 10% bonds had a 7.5% yield-to-worst and the 11.5% bonds had a 14.5% yield-to-worst.

MPC Container Ships (MPCCME)[23] - As discussed in our 1Q20 commentary, investments in bonds of shipping companies were among the largest contributors to negative performance in that quarter. We noted, however, that we were confident that these were likely to be temporary, marked-to-market losses rather than permanent impairments. This proved to be so in the case of MPC Container Ships, whose bonds we have held since 2018. Norwegian company MPC Container Ships is one of the largest owners of container vessels in the world. Anticipating a covenant breach resulting from a decline in operating performance related to coronavirus lockdowns, the company was proactive and proposed amendments to bondholders providing temporary relief. We viewed the proposal as offensive and too "shareholder-friendly," compelling us to take an activist role. We rallied bondholders and countered with a "new money" proposal. This forced the company to pursue a secondary equity offering to bolster the balance sheet and improve bondholders' collateral coverage. In addition, the bond's interest rate was increased by 150 basis points and the redemption price was increased to 104. In return, the bondholders loosened the covenants and extended the bond's maturity to March of 2023. At September 30, the bonds had rebounded to 91. We remain comfortable with the position as loan-to-value is estimated at approximately 69% and the company recently reported a 21.5% increase in fleet-weighted charter rates.

Excitedly looking below the surface,

David K. Sherman and the CrossingBridge team

Endnotes

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[1] In a clinical context, a situation in which a large percentage of a problem is subclinical, unreported or otherwise hidden from view such that only the "tip of the iceberg" is apparent.

[2] Baker, Bloom & Davis' US Economic Policy Uncertainty Composite Index, ICE Data Indices, Bloomberg

[3] For reference, China reported that 3Q20 gross domestic product grew 4.9% year over year.

[4] "Tail risk" is portfolio risk that arises when the probability of change in value greater than three standard deviations from the mean is greater than that implied by a normal distribution.

[5] Federal Reserve, ICE Data Indices, Bloomberg

[6] Federal Reserve - *Periodic Report: Update on Outstanding Lending Facilities*, March 31, 2202 through October 7, 2020 https://www.federalreserve.gov/monetarypolicy/smccf.htm

[7] As of June 30, 2020, the SMCCF owned 1.02% of the iShares iBoxx High Yield Corporate bond ETF (HYG), 4.35% of the SPDR Bloomberg Barclays High Yield Bond ETF (JNK) and 4.15% of the iShares iBoxx Investment Grade Corporate Bond ETF (LQD).

[8] Bloomberg, Federal Reserve - *Periodic Report: Update on Outstanding Lending Facilities*, March 31, 2202 through October 7, 2020 https://www.federalreserve.gov/monetarypolicy/smccf.htm

[9] Prior to the March 23, 2020 announcement of the SMCCF, the average credit spread for the ICE BofA US Corporate Bond Index (C0A0), an index of U.S. investment grade bonds, was over 400 basis points. At the end of June, the spread had narrowed to 160 basis points. With the SMCCF curtailing its purchases, the credit spread for this index has widened modestly to 185 basis points as of the end of September.

[10] The "Fed put" is a slang term for the belief that the U.S. Federal Reserve will rescue the economy by decreasing interest rates or taking other measures to mitigate a downdraft.

[11] *High Yield Credit Chartbook*, Bank of America, October 1st, 2020

[12] "Fallen angels" are investment grade bonds that have been downgraded to high yield.

[13] *Global Credit Trader: Liquidity has the Upper Hand on Downgrades (For Now)*, Goldman Sachs, October 1st, 2020

[14] Federal Reserve Bank of St. Louis, Non-Financial Corporate Businesses: Debt Securities and Loans; Federal Reserve Bank of St. Louis, Non-Financial Corporate Business: Revenue from Sales of Goods and Services

[15] Corporations in most industries found relatively easy access to the capital markets as a result of the Fed's actions, however, companies in some industries, including retail and energy, were unable to raise needed capital and, in many cases, went into bankruptcy.

[16] *US Credit Strategy Chartbook,* Deutsche Bank Research, September 30th, 2020

[17] See our 2Q19 investor letter for discussion of "zombie" companies.

[18] *Global Credit Trader: Liquidity has the Upper Hand on Downgrades (for now),* Goldman Sachs, October 1st, 2020

[19] ICE Data Indices, Bloomberg, Federal Reserve - *Senior Loan Officer Opinion Survey on Bank Lending Practices: Commercial and Industrial Loans to Large and Middle-Market Firms*

[20] Marty Fridson, noted high yield market historian and strategist, has developed the FridsonVision Fair Value Model to calculate a fair value for high yield credit spreads employing six variables: credit availability, capacity utilization, industrial production, high yield default rate, the 5-year Treasury rate and a variable reflecting ongoing quantitative easing. Highly influenced by the low level of capacity utilization as a result of the pandemic, the model suggests that the high yield credit spread, as of the end of August, should be 792 basis points higher or a spread just over 1,300 basis points. Fridson says of the wide difference between the actual level and the calculated fair value: "The explanation seems clear: By intervening on an unprecedented scale, the Federal Reserve is supporting high-yield bond prices at a level that otherwise would be unimaginable in a recession, with commercial bankers wary of extending credit to all but the safest business borrowers. In particular, the central bank's announced willingness to buy corporate bonds, including some rated less than investment-grade, has emboldened investors to pay prices they would not dream

of absent that extraordinary support.” (S&P Global Market Intelligence/LCD News, September 2 and September 22, 2020)

[21] As of 6/30/2020, our position in Golden Nugget represented 0.00% of the CrossingBridge Low Duration High Yield Fund. As of 9/30/2020, our position in Golden Nugget represented 1.98% of the CrossingBridge Low Duration High Yield Fund.

[22] As of 6/30/2020, our position in Martin Midstream Partners represented 0.00% of the CrossingBridge Low Duration High Yield Fund. As of 9/30/2020, our position in Martin Midstream Partners represented 1.29% of the CrossingBridge Low Duration High Yield Fund.

[23] As of 6/30/2020, our position in MPC Container Ships represented 0.49% of the CrossingBridge Low Duration High Yield Fund. As of 9/30/2020, our position in MPC Container Ships represented 0.57% of the CrossingBridge Low Duration High Yield Fund.

Disclosures

The prospectus for the CrossingBridge Low Duration High Yield Fund can be found by clicking here. To obtain a hardcopy of the prospectus, call 855-552-5863. Please read and consider the prospectus carefully before investing.

The Fund is offered only to United States residents, and information on this site is intended only for such persons. Nothing on this website should be considered a solicitation to buy or an offer to sell shares of the Fund in any jurisdiction where the offer or solicitation would be unlawful under the securities laws of such jurisdiction.

Definitions: **The S&P 500, or simply the S&P**, is a stock market index that measures the stock performance of 500 large companies listed on stock exchanges in the United States. **The ICE BOFA Investment Grade Index** tracks the performance of US dollar denominated investment grade rated corporate debt publically issued in the US domestic market. **The ICE BOFA High Yield Index** tracks the performance of US dollar denominated below investment grade rated corporate debt publically issued in the US domestic market. **EBITDA** is a company's earnings before interest, taxes, depreciation, and amortization is an accounting measure calculated using a company's earnings, before interest expenses, taxes, depreciation, and amortization are subtracted, as a proxy for a company's current operating profitability. **A Basis Point (BP)** is 1/100 of one percent. **Pari-Passu** is a Latin term that means 'on equal footing' or 'ranking equally'. It is an important clause for creditors of a company in financial difficulty which might become insolvent. If the company's **debts** are **pari passu**, they are all ranked equally, so the company pays each creditor the same amount in insolvency. **LIBOR** is the average interbank interest rate at which a selection of banks on the London money market are prepared to lend to one another. **Yield to Maturity (YTM)** is the total return anticipated on a bond (on an annualized basis) if the bond is held until it matures. **Free cash flow (FCF)** is the cash a company produces through its operations, less the cost of expenditures on assets. In other words, Free Cash Flow is the cash left over after a company pays for its operating expenses and capital expenditures.

Mutual fund investing involves risk. Principal loss is possible. Investments in foreign securities involve greater volatility and political, economic and currency risks and differences in accounting methods. Investments in debt securities typically decrease in value when interest rates rise. This risk is usually greater for longer-term debt securities. Investment in lower-rated and non-rated securities presents a greater risk of loss to principal and interest than higher-rated securities. Because the fund may invest in ETFs and ETNs, they are subject to additional risks that do not apply to conventional mutual funds, including the risks that the market price of an ETF's and ETN's shares may trade at a discount to its net asset value ("NAV"), an active secondary trading market may not develop or be maintained, or trading may be halted by the exchange in which they trade, which may impact a Fund's ability to sell its shares. The value of ETN's may be influenced by the level of supply and demand for the ETN, volatility and lack of liquidity. The Fund may invest in derivative securities, which derive their performance from the performance of an underlying asset, index, interest rate or currency exchange rate.

Derivatives can be volatile and involve various types and degrees of risks, and, depending upon the characteristics of a particular derivative, suddenly can become illiquid. Investments in Asset Backed, Mortgage Backed, and Collateralized Mortgage Backed Securities include additional risks that investors should be aware of such as credit risk, prepayment risk, possible illiquidity and default, as well as increased susceptibility to adverse economic developments. Investing in commodities may subject the Fund to greater risks and volatility as commodity prices may be influenced by a variety of factors including unfavorable weather, environmental factors, and changes in government regulations. Shares of closed-end funds frequently trade at a price per share that is less than the NAV per share. There can be no assurance that the market discount on shares of any closed-end fund purchased by the Fund will ever decrease or that when the Fund seeks to sell shares of a closed-end fund it can receive the NAV of those shares. There are greater risks involved in investing in securities with limited market liquidity.

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The performance data quoted represents past performance. Past performance does not guarantee future results. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance quoted. Performance data current to the most recent month end may be obtained by calling 914-741-9600. Please click here for current standardized performance as of the most recent quarter-end.

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A stock may trade with more or less liquidity than a bond depending on the number of shares and bonds outstanding, the size of the company, and the demand for the securities. The Securities and Exchange Commission (SEC) does not approve, endorse, nor indemnify any security.

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