CrossingBridge Low Duration High Yield Fund (CBLDX)

Quarterly Fund Update: 2Q 2018

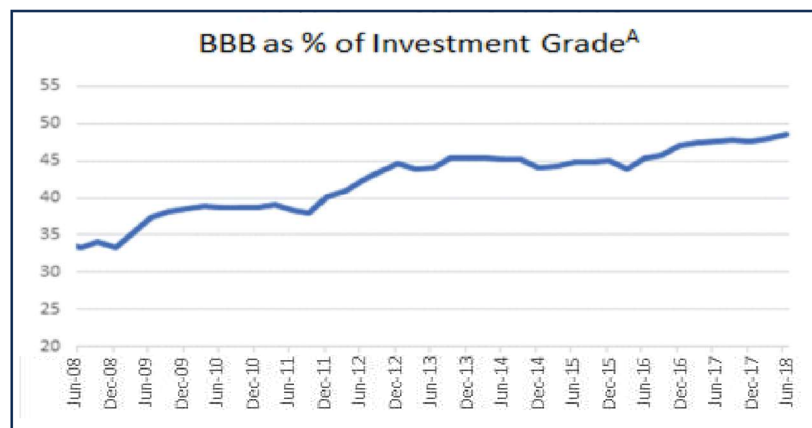
Inception: 01/31/2018	Q2 2018	1 Month	Since Inception
Share Class I	0.61%	0.16%	1.00%
ICE BofAML 0-3 Yr US HY Index Ex-Financials	1.70%	0.33%	1.61%
ICE BofAML 1-3 Yr Corporate Bond Index	0.47%	0.00%	0.25%
ICE BofAML 0-3 Yr US Treasury Index	0.30%	0.06%	0.48%

The performance data quoted represents past performance. Past performance does not guarantee future results. All performance is annualized except where the length of performance history is less than 1 year. 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. For Share Class I, the gross expense ratio is 1.32% and the net expense ration is 1.00%. For Share Class I, there is a 0.90% expense cap in place through January 8, 2020. The Gross and Net Expense Ratios are as of the prospectus dated January 8, 2018. Investment performance reflects contractual fee waivers in effect through January 8, 2020. In the absence of such fee waivers, total return would be reduced. The net exoense ratio per the prospectus is the fee applicable to the investor. Performance data current to the most recent month end may be obtained by calling 1-888-898-2780. Investment performance reflects contractual fee waivers. ***See additional Fund disclosures on page 8.***

Float Like a Butterfly, Sting Like a (Triple) B[1]

When underdog Muhammad Ali made his original boast, he was putting his opponent, world heavyweight champ Sonny Liston, on notice that he might be mesmerized by Ali's agile footwork, but he better watch out for the lightning jab that would knock him out. Steady economic growth over the past several years has similarly captivated fixed income investors, lulling them into complacency despite the bobbing and weaving of geopolitics and central bank policy. At this time, we are compelled to highlight two factors that may become the knockout punch for fixed income investors:

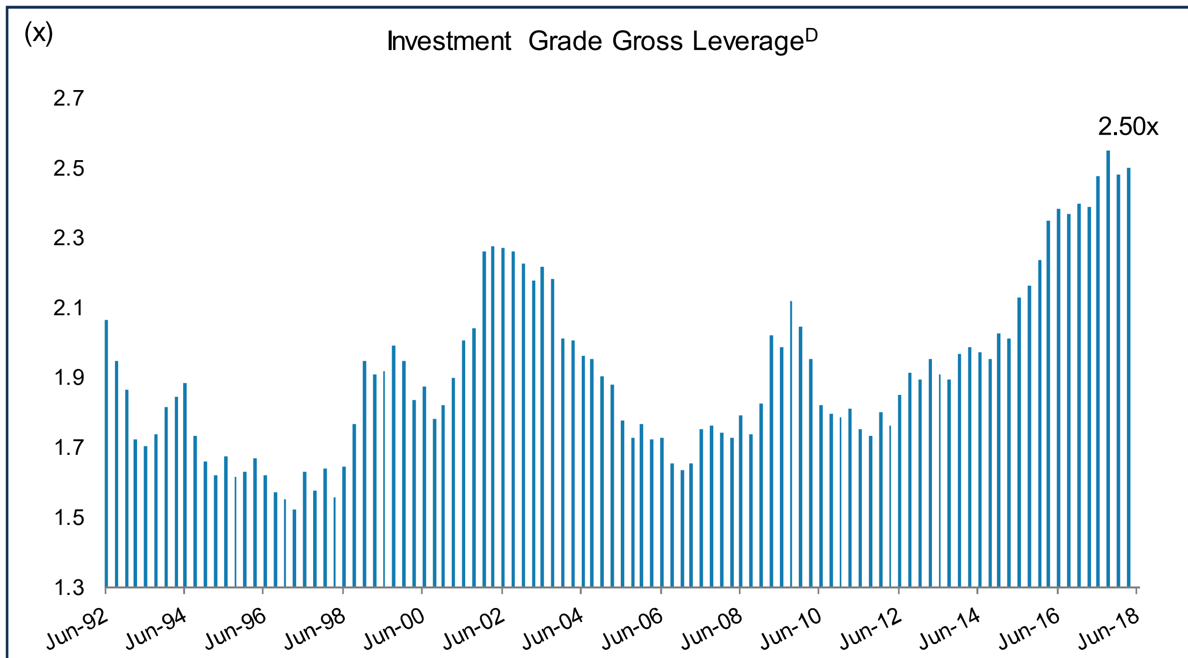
- increasingly loose underwriting standards which are raising credit risk and
- the growth of the BBB market which is driving up potential supply via "fallen angels"[2] that would create technical risks for the high yield market.



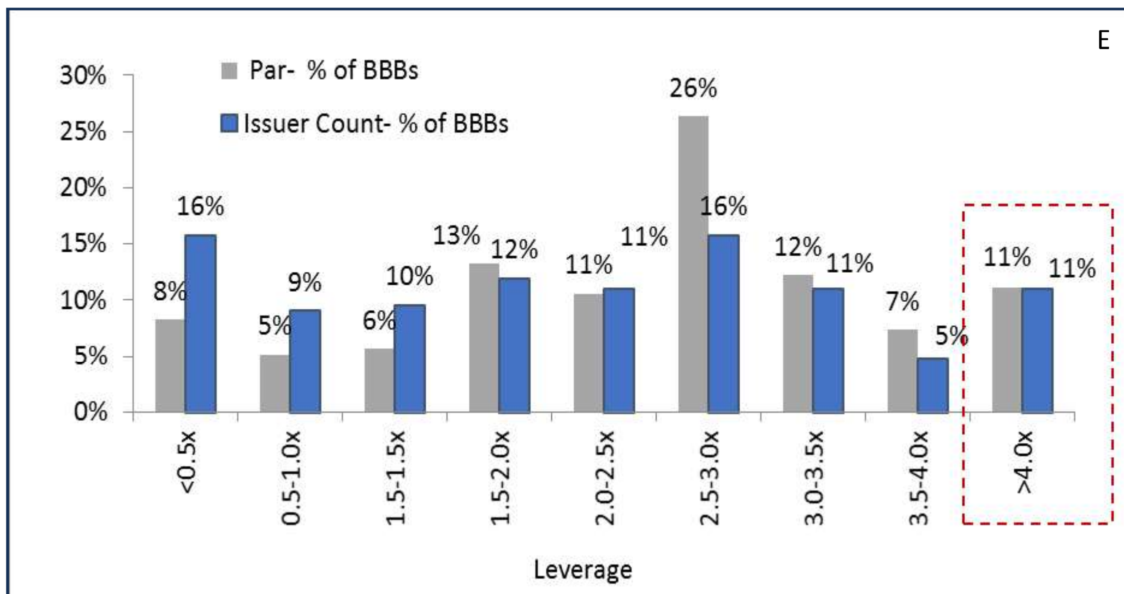
1 Paraphrasing Cassius Clay, later known as Muhammad Ali, who said he would "Float like a butterfly, sting like a bee. The hands can't hit what the eyes can't see" shortly before his 1964 bout which he would go on to win by technical knockout and earn Ali his first heavyweight title.

2 Falling angels are bonds that have been downgraded in credit rating and are no longer considered investment grade debt.

Overall, the credit quality of the investment grade corporate bond market has declined due to higher concentration of BBB credits which currently make up approximately 50% of the market.[B] Further, gross leverage has climbed to a 25-year high which is at least 10% higher than the peaks seen during the telecom bubble of 2001-02 and during the Great Recession of 2008-09.[C]



Moreover, as shown below, 11% of BBB credits have leverage greater than 4x EBITDA, a level usually associated with high yield bonds.with high yield bonds.

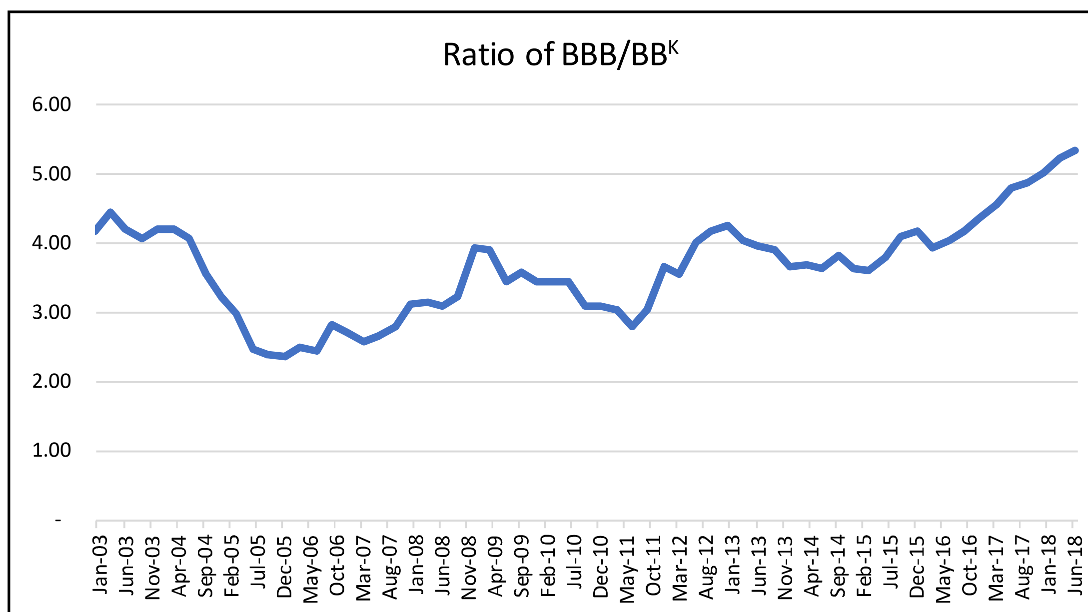


The cause of this shift within the investment grade market is pretty clear. Yield-hungry fixed income investors have been willing to move down in credit quality in the current low interest rate environment. This has been reflected in the narrowing of credit spreads, which reached a cycle low for investment grade in February of this year.[F] Facing a low growth environment, with limited pricing power and few remaining levers to pull to increase profitability, corporate leaders have shown themselves to be more tolerant of credit downgrades and have been willing to take advantage of low interest rates to make acquisitions, increase dividends and repurchase stock to benefit shareholders. The repatriation component of the new tax law further encourages this behavior as many companies with significant offshore cash balances have used their cash reserves to execute large share repurchase programs, enriching shareholders to the detriment of bondholders as they increase net leverage.
With respect to acquisitions, acquirers typically pledge to the rating agencies that they will dedicate future cash flow to debt reduction in order to return to a leverage level more appropriate for their credit rating. We have seen a wave of acquisitions based on similar strategic initiatives in an array of industries such as packaged food and consumer products.[3] While these deals appear strategic, most have resulted in a step up in leverage, sometimes rising above 5x.[G] Management's execution following these acquisitions requires many things to go right and synergies realized for these companies to return to traditional investment grade metrics. Meanwhile, the rating agencies allow these companies to retain investment grade status based on a hope of de-leveraging through improved cash flow and/or debt reduction.

A case in point is AT&T. In February 2015, AT&T was downgraded by S&P from A- to BBB+ as a result of their pending acquisition of DirecTV. Similarly, S&P downgraded AT&T further, to BBB, when it closed the purchase of Time Warner in June 2018. These actions have resulted in AT&T's net leverage increasing from 2.3x to 2.9x, above the average for the investment grade market.[H] However, when one considers AT&T's post-employment benefit obligations, capital leases and operating leases, which will have to be included on companies' balance sheets beginning in 1Q19[4], AT&T's net leverage is nearly 3.9x, arguably more deserving of a high yield credit rating. Craig Moffett, a well-known telecom analyst has spoken and written extensively about AT&T[5] and opined that the acquisition of Time Warner required that AT&T take on significant incremental leverage yet will afford the company limited benefit. In summary, he points out that Time Warner represents 15% of the revenues and 20-22% of EBITDA of newly-constituted AT&T. However, given that the company's legacy businesses, representing 85% of revenues, are experiencing ongoing organic decline in revenues and margins, the acquisition of Time Warner will do little to improve the company's prospects over the long run. In their report initiating credit research coverage of AT&T[6], Morgan Stanley echoed this view, forecasting that free cash flow will be only 3.5% of funded debt[7], leaving little, if any, excess cash flow to de-lever. As further demonstrated by its recently announced acquisition of AppNexus, AT&T is clearly intent on redirecting its challenged business model through acquisitions that may not pan out. We are skeptical and in agreement with the bearish views.[I]

AT&T has become the largest non-financial issuer of corporate bonds with over $160 bn outstanding. The company is a prime candidate to become a "fallen angel" – a credit that is downgraded from investment grade to high yield. On its own, this is startling, but, in context of the high yield market, an AT&T downgrade to junk would increase the supply of BBs by nearly 28% and pressure high yield spreads to widen.[J]

3 Examples include Conagra, Campbell Soup, McCormick, Bacardi, AB Inbev and Keurig Dr. Pepper
4 Per new FASB Accounting Standards Update No. 2016-02: Leases (Topic 842), issued February 2016
5 AT&T: Curb Your Enthusiasm, Downgrading to Sell, MoffettNathanson LLC, June 13, 2018
6 Time Out: Launching Coverage of AT&T and Verizon, Morgan Stanley, June 26, 2018
7 Funded debt is approximately $180 bn. Fully loaded debt, including capital and operating leases as well as unfunded post-employment benefit obligations is approximately $250 bn, suggesting that free cash flow will be only 2.5% of full-loaded debt obligations.



More broadly, it is useful to recognize that the universe of BBB bonds is 5.3x the size of the BB market, reflecting nearly a 70% increase in this ratio over the last ten years. In our 2015 year-end letter, we highlighted our concern that increasing downgrades among energy credits would cause technical pressure and widening spreads in the high yield market, which ultimately occurred. A study by Marty Fridson[8], a long-time, well-respected leveraged finance market expert, recently supported this view[9], concluding that large-scale downgrading of credits from BBB to BB is likely to lead to credit spread widening among high yield bonds of 50-60 bp. To assess the impact on credit spreads of large-scale downgrades, Fridson focused on the 2016 plunge in energy prices, involving $22 bn of fallen angels, and the 2005 downgrade of $45.5 bn of General Motors bonds to high yield. Given the greater size of the whole BBB market, approximately $3.1 trillion, versus the universe of BB credits, approximately $578 bn, an influx of downgrades would likely have an even greater impact, swamping the BB market. There have been four peaks in fallen angel volume since 2000[10] when fallen angels, on average equaled 13% of the BBB portion of the investment grade market.[11] In the next recession, we believe the fallen angel ratio will be worse. However, the historic fallen angel rate implies that downgrades, excluding a potential AT&T downgrade, would exceed $400 bn which would increase supply in the BB market by approximately 69%.[L] This would be the “sting” of the BBBs.

Seeking to enhance portfolio returns in a low yield environment, we are selectively taking advantage of opportunities presented by the increase in M&A activity. When making an acquisition, corporations and private-equity investors often find it beneficial to lock up financing before the deal is completed to assure the sellers that they

8 Marty Fridson is the Chief Investment Officer of Lehmann Livian Fridson Advisors, LLC and regularly publishes his research regarding the leveraged finance market.
9 How will BBB downgrades affect the high-yield market?, Marty Fridson for Leveraged Commentary & Data, lcdcomps.com. After publishing his study, Fridson, in an article on ftalphaville.ft.com, The herds and the BBBs, noted that David Sherman of Cohanzick was the inspiration for his study on the impact of large scale downgrades on credit spreads. (https://ftalphaville.ft.com/2018/07/12/1531407407000/The-herds-and-the-BBBs-/)
10 The specific years for fallen angel peaks were 2002, 2005, 2009 and 2016.
11 US Credit Alpha, Barclays, June 29, 2018

have the necessary financing. Under such circumstances they may solicit "bridge" commitments from investors willing to agree in advance to provide the financing in exchange for a small fee. Then, the issuer will go to market seeking more attractive financing that replaces the bridge commitment which, if funded, would have more onerous interest cost and terms. In providing the bridge, the investor has essentially sold a "put" in exchange for a commitment fee and the investor is now at risk of having to lend to the company, an unfortunate event known as a "hung bridge". Generally, we are not big fans of this business because we don't think the loan we could get stuck with is adequately priced. That said, occasionally, we are offered the opportunity to participate in a bridge which, if hung, we would be content to own.

Heartland Dental ("HEARTL")[M] -- A bridge that went according to plan in which we participated was Heartland Dental Holdings. Heartland is the largest dental support organization in the US. In March 2018, Kohlberg Kravis Roberts & Co. L.P., the equity sponsor, agreed to acquire a majority stake in the company for $2.75 bn. As part of the financing, the buyer offered a $310MM unsecured bridge facility with participants receiving up to 50 bp for the commitment. The equity sponsor expected to replace the bridge commitment with newly-issued unsecured bonds concurrent with the closing of its investment. If participants were required to fund the bridge loan, however, the coupon would be LIBOR + 6%, stepping up 50 bp every 3 months to a coupon cap of 9%. With a credit profile that showed a high level of cash generation that could be used to repay debt, the 8-year bond issue was well received and priced at 8.5%. Moreover, our participation in the bridge gave us preferential treatment to partake in the new bond issue. By participating in the bridge commitment, we enhanced portfolio return via the commitment fee received.

McDermott International ("MDR")[N] -- Sometimes a bridge commitment does not go exactly as planned and we get stuck with a piece of paper on terms we found attractive. McDermott International is a worldwide offshore energy service company which was strategically acquiring Chicago Bridge & Iron ("CBI"), a provider of similar services for onshore clients. McDermott arranged a $1.5 bn bridge commitment to assure CBI shareholders that financing was in place. When it came time to syndicate the permanent financing in late March, the high yield market was in a funk and was less willing to finance a transaction levered at 3.2x in an industry known for lumpy revenues and cash flow. With McDermott in a "must fund" position to ensure that it could close the acquisition, prospective bond buyers sensed an opportunity to extract a very high yield. Per our bridge commitment, we were required to fund, purchasing the new 10.625% bonds, due 2024, at an effective price of 96. The banks that sponsored the bridge deal were required to fund their portion of the bridge and agreed to sell at the market clearing price, 94.75 (a yield-to-maturity of 11.89%), initially causing a negative mark-to market for our position. However, with the overhang gone and the high yield market reversing course, investors were eager to capture a yield over 11%. Subsequently, the bonds traded up and we took the opportunity to reduce our position at levels above the bridge terms resulting in a return that far exceeded the initial commitment fee.

AT&T ("T")[O] -- The extended approval process for AT&T's acquisition of Time Warner provided us with the opportunity to participate in a "reverse bridge", earning high short term returns despite AT&T's investment grade rating. In July 2017, AT&T issued $22.5 bn of new unsecured bonds to finance its anticipated purchase of Time Warner. The bonds had a unique term, the Special Mandatory Redemption ("SMR"), that required that, if the deal were not completed by April 22, 2018, AT&T would be required to redeem the bonds at a price of 101 plus accrued interest. Unlike a typical bridge commitment, AT&T issued the new bonds to assure the market that the funding was in hand with an agreement to repurchase the bonds if the deal did not go through. Given the size of the financing required, AT&T likely thought it was prudent to issue the financing to a willing market rather than risk future pricing uncertainty. With the government taking AT&T to court to attempt to halt the deal and neither side willing to settle, it became apparent, by the beginning of April 2018, that the deal would not be completed

by the SMR date and that AT&T would be required to redeem the bonds. Thus, throughout April, we purchased the bonds at a 4-6% annualized yield to the late May expected redemption date. As anticipated, the bonds were redeemed on May 23.

Conclusion

A wave of downgrades, an increase in credit stress and a rising rate environment is likely to cause price declines for good credits as well as bad; thus, our high level of short-term investments and low duration will provide us with dry powder to make good investments at more attractive levels. Meanwhile, we are increasingly wary of BBB credits and are being very selective in making new commitments to high yield bonds and leveraged loans. In the context of these concerns, we will continue to evaluate unique situations that will enhance portfolio returns such as event-driven opportunities.

Later in life, Muhammad Ali said, "The man who views the world at 50 the same as he did at 20 has wasted 30 years of his life." With the experience of our team, we believe we have the ability to "rope-a-dope"[12]this market while waiting to take advantage of opportunities when they present themselves.

David Sherman and the CrossingBridge team

12 The rope-a-dope is a boxing style most commonly associated with Muhammad Ali in which a boxer takes a defensive position and conserves strength while the opponent wears out throwing blows that ineffectively land on hands and arms. Meanwhile the boxer looks for opportunities to successfully land counterpunches.

Endnotes

A: Source: CrossingBridge, Bloomberg
B: Source: Bloomberg
C: Source: CrossingBridge, Morgan Stanley
D: Source: CrossingBridge, Morgan Stanley
E: Source: Credit Suisse
F: Source: Bloomberg, Barclays
G: Source: CrossingBridge, Cantor Fitzgerald
H: Source: CrossingBridge
I: Source: CrossingBridge
J: Source: Bloomberg
K: Source: CrossingBridge, Bloomberg
L: Source: CrossingBridge, Bloomberg, Barclays
M: During 2Q2018, the CrossingBridge Low Duration High Yield Fund had a committment of $130,000 of Heartland Dental Bridge Loan which expired without the requirement to fund.As of 3/31/2018, our position in Heartland Dental represented approximately 2.33% of the portfolio. As of 6/30/2018 our position in Heartland Dental represented 0.0% of the portfolio.
N: During 2Q2018, the CrossingBridge Low Duration High Yield Fund had a committment of $147,000 of McDermott International Bridge Loan which was effectively funded. As of 3/31/2018 our position in McDermott International represented approximately 4.09% of the portfolio. As of 6/30/2018 our position in McDermott International represented approximately 0.13% of the portfolio.
O: During 2Q2018, the CrossingBridge Low Duration High Yield Fund bought and sold $202,000 of AT&T Inc. 5.15% due 2/14/2050. As of 3/31/2018 our position in AT&T 5.15% due 2/14/2050 represented approximately 0.0% of the portfolio. As off 6/30/2018 our position in AT&T 5.15% due 2/14/2050 represented 0.0% of the portfolio.

Fund Disclosures

Opinions expressed are subject to change at any time, are not guaranteed and should not be considered investment advice.

Fund Holdings and sector allocations are subject to change and should not be considered a recommendation to buy or sell any security.

The fund's investment objectives, risks, charges and expenses must be considered carefully before investing. The statutory and summary prospectus contain this and other important information about the investment company, and it may be obtained by calling 1-888-898-2780 or visiting our website at: https://www.crossingbridgefunds.com/literature. Read it carefully before investing.

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. The fund may make short sales of securities, which involves the risk that losses may exceed the original amount invested. 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.

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