Searching for Value: 
Our Disciplined Adherence to a Bottom-up Credit Framework

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Thornburg Strategic Income Fund’s goal is to provide steady income in diverse macroeconomic environments. The small team structure of the fixed-income group allows us to be nimble and analyze individual investments across sectors, geographies, asset classes, and capital structures. The model allows us to see connections between situations, act opportunistically, and find compelling relative value. And our bottom-up investment discipline helps us to identify neglected opportunities and avoid common pitfalls.

A Wide-Angle View
Let’s use a wide-angle lens to understand why a consistent credit framework is important. Market participants are stirred and buffeted by “greed, sloth, and fear.” So markets are sometimes oversold, sometimes overbought, and sometimes complacent. In our quest for steady income, a consistent credit framework helps us to temper the pangs that cloud judgment.

Ultimately, we try to obtain the most reward while assuming the least risk. In corporate credit, the reward comes from both income and capital gains. The risk comes from not receiving promised income or from not repaying our principal in full, and on time. Since the reward and upside is usually contractually well defined, our framework dwells heavily on understanding downside risk. And here, riskiness can be bisected into two components: 1) How likely is the company to default? 2) Should said company default, how much of our investment will we recover?

While an exhaustive review of all risk factors is beyond the scope of this piece, we will discuss the most important in answering these questions.

Going Bust
Companies default on maturities and interest payments for a variety of reasons. The margin of safety from default lies in evaluating the potential sources of cash—including cash on hand, cash flows from business operations, asset sales, or refinancings—relative to the burden of principal and interest payments. While principal and interest payments are usually well understood, potential sources of cash are more nebulous. So, our analysis focuses on several external (cycles, secular headwinds, and shocks) and internal factors (management behavior and constraints) to better understand potential sources of cash.

Cycles Come and Go
Economies follow a pattern of boom and bust. We take a view on where the economy is in the cycle and we also estimate how sensitive a particular company’s cash flows may be to cyclical changes. With a view on a company’s cyclical sensitivity, we also think about what happens if we’re wrong about our view on the cycle and economic demand is weaker than expected. Our aim is to understand a company’s cash flow resilience through various economic scenarios.

Down, But Not Out (Yet)
Secular decline is a theme in many industries. Technological change has created new industries but also destroyed others. For example, the internet and digital revolution reduced the cost and increased the convenience of information exchange; the result has been a decline in

the newspaper, newsprint, and printing industries. Secular decline can also come from shifts in culture and consumer tastes, which impact restaurateurs, food manufacturers, and apparel retailers. Another source can come from regulatory change, which can impose or relieve costs and risks of doing business. For example, environmental mandates on coal power have favored renewable energy at the expense of certain coal-mining regions. And yet another secular driver is demographic change, including wealth, age, and immigration. The impact is felt in health care, education, and infrastructure demand. We attempt to assess the risk of secular decline.

**Shock Treatment**

So far we’ve discussed relatively slow-acting factors impacting the cash flows of a business. However, there can be sudden, catastrophic events that impair a business. Examples include labor action at coal mines, the September 11, 2001, attacks and SARS reducing airline travel, and the Fukushima reactor meltdown’s impact on the Japanese nuclear power industry. Businesses withstand shocks better when they have flexible cost structures as well as redundancies, alternatives, and substitutes in operations, customers, and suppliers. Though there are always “unknown unknowns” (as Donald Rumsfeld dubbed them), we look for companies that can survive various stress events that may disrupt or interrupt a business.

**Choices Matter, But So Do Constraints**

A business’ fate is partly determined by the hand dealt to it (cycles, secular headwinds, and shocks); but also by how it prepares and plays its hand. Business managers can make various operating, financial, and legal decisions that either improve or impair their ability to withstand negative developments. Instead of using cash to build cash reserves or reduce debt, management teams can make negative choices to buy bad businesses, return cash to equity investors, or spend on risky expansion plans. Management teams can also choose to operate their businesses aggressively with lax controls, increasing the potential for industrial accidents or product liability. They can also choose to take on inflexible customer or supplier agreements that increase business risk, including taking on customers without minimum purchase requirements, without the ability to pass on cost increases, or without hedging foreign-exchange risks. Lastly, management teams can choose to operate with transparency (providing timely reports and access to investors) or in the dark. And just as some management teams have a track record of honesty, others have a history of misguidance, shenanigans, and outright fraud. Though they have a lot of discretion in how they run their business, management teams can be constrained by bond indentures and loan agreements. These constraints can limit capital expenditures, debt, and interest burden relative to cash flows and payments to equity holders—among other things. We dig deeply to understand management philosophy and the constraints on their behavior.

**Strategic Income Fund Performance** *(as of 6/30/16)*

<table>
<thead>
<tr>
<th>AVERAGE ANNUAL TOTAL RETURNS</th>
<th>1-YR</th>
<th>3-YR</th>
<th>5-YR</th>
<th>SINCE INcep</th>
</tr>
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<tbody>
<tr>
<td>A Shares (TSIAx Incep: 12/19/07)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Without sales charge</td>
<td>1.32%</td>
<td>3.23%</td>
<td>4.50%</td>
<td>6.37%</td>
</tr>
<tr>
<td>With sales charge</td>
<td>-3.25%</td>
<td>1.66%</td>
<td>3.54%</td>
<td>5.80%</td>
</tr>
<tr>
<td>I Shares (TSIIx Incep: 12/19/07)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1.66%</td>
<td>3.57%</td>
<td>4.81%</td>
<td>6.70%</td>
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</tr>
<tr>
<td>Barclays U.S. Universal Index</td>
<td>5.82%</td>
<td>4.20%</td>
<td>4.01%</td>
<td>4.85%</td>
</tr>
<tr>
<td>Blended Index</td>
<td>4.37%</td>
<td>4.75%</td>
<td>4.49%</td>
<td>4.56%</td>
</tr>
</tbody>
</table>

Blended Index: 80% Barclays U.S. Aggregate Bond Index and 20% MSCI World Index.
Not annualized for periods less than one year. 30-Day SEC Yield: A shares, 4.98%; I shares, 5.56%.

Performance data shown represents past performance and is no guarantee of future results. Investment return and principal value will fluctuate so shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than quoted. For performance current to the most recent month end, visit thomburg.com or call 877-215-1330. A shares have a maximum sales charge of 4.50%. There is no sales charge for class I shares. The total annual operating expenses for the Fund are as follows: A shares, 1.23%; I shares, 0.89%.

The Barclays U.S. Aggregate Bond Index is composed of approximately 8,000 publicly traded bonds including U.S. government, mortgage-backed, corporate and Yankee bonds. The index is weighted by the market value of the bonds included in the index. The MSCI World Index is an unmanaged market-weighted index that consists of securities traded in 23 of the world’s most developed countries. Securities are listed on exchanges in the U.S., Europe, Canada, Australia, New Zealand, and the Far East. The index is calculated with net dividends reinvested, in U.S. dollars. The Barclays U.S. Universal Index represents the union of the U.S. Aggregate Index, U.S. Corporate High-Yield Index, Investment-Grade 144A Index, Eurodollar Index, U.S. Emerging Markets Index, and the non-ERISA eligible portion of the CMBS Index. The index covers USD-denominated, taxable bonds that are rated either investment-grade or below investment-grade.
which are 1) the priority of payment and 2) the realizable value of collateral.

**How Is the Pie Divided?**

When an event of default approaches or occurs, a contest ensues between the management, equity holders, various creditors, suppliers, workers, and other stakeholders for preservation of their respective interests, including employment contracts, equity ownership, bond principal, supplier contracts, and pensions. When we invest in a bond or loan, we have a contract spelling out our claim (or lack thereof) to various collateral and guarantees. This sets out one of the ways realized value should be allocated between contesting stakeholders. It is not the only way. Every country has a different resolution framework for handling claims, and that may not adhere strictly to or may supersede contractual terms. The resolution framework can vary widely: impersonally legalistic or not; hyper-nationalistic or not; and precedent-rich or not. It can favor creditors or owners or workers to varying degrees. With the rights and limitations of our contract in mind, we work to understand the resolution process in order to determine the negotiating rules and then evaluate the negotiating position of each party. This gives us a view of how assets will be divided among stakeholders and, ultimately, to our investment position.

**How Big Is the Pie?**

Once we have a view on the priority of payment, we then look to understand the amount of value that will be apportioned. The sources of value can come from proceeds of asset sales or new securities (equity, warrants, bonds) or a mix of both. We can make estimates of realizable value using many approaches, including comparable transactions, comparable operating metrics, and discounted cash flows. Often, the resolution framework itself interferes to depress realizable value. For example, courts may order an unnecessarily speedy auction without appropriate notice, preparation, and transparency to attract enough bidders. Moreover, some expensive, legalistic, and drawn-out resolution frameworks may result in lower sale proceeds after legal expenses are netted. We try to come up with the potential realizable value not as the business is today, but under stressed scenarios.

**Tying It Together**

As you might have surmised, and without fleshing out the details, our bottom-up process of assessing downside risk is very intense and is how we spend the bulk of our time. With our framework in mind, we draw on various sources to supplement, inform, test, and challenge our opinions. Sources include company financial statements and reports; interviews of industry participants (including management teams, consultants, etc.); reading industry publications (other investment analysts, journalists, etc.); a thorough examination of legal documentation and conferences with lawyers; but, foremost, the vast base of experience across Thornburg’s investment team. In assessing downside risk, we try to understand a company’s margin of safety from defaulting by evaluating its resilience through cycles, secular headwinds, and event risks given management’s choices and constraints. We then combine this evaluation with an assessment of how much value we might receive, given stressed valuations and the priority of our claim.

This bottom-up approach helps us to clearly evaluate and identify opportunities through times of market euphoria and complacency—as well as pessimism and paranoia. It is a common language we use to hold ourselves accountable when conducting due diligence and to debate relative-value opportunities with colleagues. Alongside our flexible team structure, the bottom-up credit framework is a cornerstone of Thornburg’s philosophy and a differentiating advantage.
IMPORTANT INFORMATION

The views expressed by Mr. Hassan reflect his professional opinions and are subject to change.

There is no guarantee that the Fund will meet its investment objectives.

Diversification does not assure or guarantee better performance and cannot eliminate the risk of investment losses.

The performance of any index is not indicative of the performance of any particular investment. Unless otherwise noted, index returns reflect the reinvestment of income dividends and capital gains, if any, but do not reflect fees, brokerage commissions or other expenses of investing. Investors may not make direct investments into any index.

Investments carry risks, including possible loss of principal. Portfolios investing in bonds have the same interest rate, inflation, and credit risks that are associated with the underlying bonds. The value of bonds will fluctuate relative to changes in interest rates, decreasing when interest rates rise. This effect is more pronounced for longer-term bonds. Unlike bonds, bond funds have ongoing fees and expenses. Investments in lower rated and unrated bonds may be more sensitive to default, downgrades, and market volatility; these investments may also be less liquid than higher rated bonds. Investments in derivatives are subject to the risks associated with the securities or other assets underlying the pool of securities, including illiquidity and difficulty in valuation. Investments in equity securities are subject to additional risks, such as greater market fluctuations. Additional risks may be associated with investments outside the United States, especially in emerging markets, including currency fluctuations, illiquidity, volatility, and political and economic risks. Investments in the Fund are not FDIC insured, nor are they bank deposits or guaranteed by a bank or any other entity.

Class I shares may not be available to all investors. Minimum investments for the I share class may be higher than those for other classes.

Before investing, carefully consider the Fund’s investment goals, risks, charges, and expenses. For a prospectus or summary prospectus containing this and other information, contact your financial advisor or visit thornburg.com. Read them carefully before investing.