

Active vs. Passive: US High Yield

Executive Summary

Historically, US high yield ETFs have underperformed the most commonly referenced market indices, and typically rank 3rd or 4th quartile when comparing risk-adjusted returns to those of a subset of active managers. Additionally, SKY Harbor's analysis suggests ETFs are poorly positioned to take advantage of the key opportunities and defend against the key risks found at the intersection of our top-down and bottom-up research process. As such, we think historical risk-adjusted returns make a compelling case for active management in US high yield, and believe the ability to position portfolios to capture SKY Harbor's highest-conviction market themes – which ETFs are unable to do – will prove beneficial for our relative performance.

SKYView: Active vs. Passive Management

In past *Weekly Briefings* (the most recent found [here](#)), SKY Harbor has compared performance of the largest US high yield ETFs (HYG and JNK, along with short duration subsets SHYG and SJNK) to ICE BofA US High Yield indices (both broad market and short duration), as well as a dataset of active high yield managers, all in an effort to gauge relative performance between active and passive strategies within our market niche. Past analysis found that US high yield ETFs were unfavorable proxies for broad and short duration US high yield market risk, as demonstrated by weak total return capture and heightened volatility in comparison to the ICE BofA US High Yield Index (ticker H0A0) and its short duration high yield subset (ticker JVC4). In this research piece, we update our findings through Q2'20, and expand upon this analysis through the identification of key opportunities we believe will drive improved risk-adjusted returns in the current market environment. These opportunities, in our view, stem from pricing inefficiencies within parts of the market ignored by ETFs.

By way of background, the two largest ETFs in the US high yield space – iShares iBoxx High Yield Corporate Bond ETF (ticker: HYG) and SPDR Bloomberg Barclays High Yield Bond ETF (ticker: JNK) – have grown materially since inception (late 2007), and together now possess assets in excess of \$43bn. The two largest ETFs in the short duration US high yield space – iShares 0-5 Year High Yield Corporate Bond ETF (ticker: SHYG) and SPDR Bloomberg Barclays Short Term High Yield Bond ETF (ticker: SJNK) – have grown since 2013, and together now possess assets of nearly \$8bn. In aggregate, these four ETFs account for ~ 3.5% of the size of the US high yield market, with performance data (going back many years and spanning both up and down markets) robust enough to allow for a comparison with appropriate index and active manager return streams.

Short Duration US High Yield ETFs vs. the ICE BofA 1-5 Year BB-B US High Yield Constrained Index (JVC4)

We preface this section of our analysis with the disclosure that neither SHYG nor SJNK use the same benchmark as most active short duration US high yield managers. The benchmark for SHYG is the Markit iBoxx USD Liquid High Yield 0-5 Index, a market capitalization-weighted index consisting of liquid USD high yield bonds maturing within 5 years, while the benchmark for SJNK is the Bloomberg Barclays US High Yield \$350mn Cash Pay 0-5 Yr 2% Capped Index, an index designed to track a more liquid subset of USD-denominated high yield securities. Active high yield managers, on the other hand, typically use one of several short duration high yield market indices created by ICE BofA, or are non-benchmarked strategies (typically seeking a % capture of the broad high yield market returns with limited volatility). For this analysis, we will be using the ICE BofA 1-5 Year BB-B US High Yield Constrained Index (JVC4), one of the most commonly used benchmarks in the active space, as a proxy for the short duration US high yield index. Since a significant portion of the buyer base may view SHYG and SJNK as alternatives to actively managed short duration high yield exposure, we believe the comparison is a fair one to make.

Using data going back to 2014 (the first full year in which both ETFs have available statistics), SKY Harbor compared performance of the short duration high yield ETFs to JVC4, presented below in terms of relative capture.

ICE BofA 1-5 Yr BB-B US High Yield Index (JVC4) vs. iShares 0-5 Yr High Yield Corporate Bond ETF (SHYG) and SPDR Bloomberg Barclays Short Term High Yield Bond ETF (SJNK)
monthly data, since 2014

Returns	2014	2015	2016	2017	2018	2019	U/P vs. Index % of Periods
JVC4 Total Return	1.7%	-3.0%	12.2%	5.4%	0.7%	11.0%	
SHYG Capture	19%	125%	102%	95%	3%	90%	83%
SJNK Capture	-73%	209%	116%	98%	-40%	86%	83%

Returns (through June 30, 2020)	YTD	Rolling (annualized)		
		1yr	3yr	5yr
JVC4 Total Return	-4.6%	-1.4%	2.8%	3.6%
SHYG Capture	121%	217%	65%	84%
SJNK Capture	91%	142%	77%	82%

Standard Deviation of Returns	2014	2015	2016	2017	2018	2019	U/P vs. Index % of Periods
SHYG Capture	109%	107%	73%	118%	122%	133%	83%
SJNK Capture	121%	117%	113%	126%	132%	132%	100%

Standard Deviation of Returns	YTD	Rolling (annualized)		
		1yr	3yr	5yr
SHYG Capture	92%	92%	97%	97%
SJNK Capture	100%	100%	103%	107%

Source: SKY Harbor, ICE BofA Indices, Bloomberg

Note: ETF returns are calculated on a price basis; both JVC4 and ETF returns and standard deviations are calculated using monthly data

As demonstrated above, on an annualized basis using monthly returns from the start of 2014 until the end of 2019, ETF performance has been weak relative to the ICE BofA 1-5 Year BB-B US High Yield Constrained Index. In fact, **over the six-year data set shown above, SHYG and SJNK only outperformed JVC4 in 2016**. Additionally, we would note that total returns are not the only metric investors are concerned with – the volatility of those returns is also a meaningful part of this comparison. Looking at annualized standard deviation of returns, again using monthly data, we find that both ETFs exposed the buyer to greater volatility relative to JVC4 in every year except 2016 (SHYG showed less volatility than the index). Rolling returns through June 30, 2020 on a YTD, 1yr, 3yr, and 5yr basis show a similar story, with both ETFs underperforming JVC4. **In summary, we would conclude that on an annualized basis through the period of our data set, ETFs appear to pick up, on average, ~ 75% of JVC4 total returns with ~ 105% of the index volatility.**

We concede, however, that this comparison is somewhat unfair. Investors cannot get direct exposure to the ICE BofA 1-5 Year BB-B US High Yield Constrained Index, and index performance benefits from no management fee, no transaction costs (frictional costs can be quite high, especially in less liquid markets), and an unlimited ability to gain exposure to any and all securities, even those that are illiquid and unavailable for actual purchase. Recognizing this, we attempt to level the playing field, and continue our analysis below, this time comparing ETFs to active managers.

Short Duration US High Yield ETFs vs. Active Managers

Using the eVestment Global Database, SKY Harbor created a data set of > 30 managers with short duration US high yield strategies. Below, we compare returns (net of fees) of the median manager within our data set to both SHYG and SJNK. **The data below shows that short duration ETFs underperformed the median active manager in four of six years tested (67% of the time), and demonstrated greater volatility in all periods.**

Median Active Short Duration HY Manager vs. iShares 0-5 Yr High Yield Corporate Bond ETF (SHYG) and SPDR Bloomberg Barclays Short Term High Yield Bond ETF (SJNK)

monthly data, since 2014

Returns	2014	2015	2016	2017	2018	2019	U/P vs. Median Mgr. % of Periods
Median Short Duration Manager (net of fees)	1.2%	-0.3%	9.7%	4.7%	0.3%	12.3%	
SHYG Capture	28%	1175%	129%	109%	6%	81%	67%
SJNK Capture	-108%	1962%	146%	112%	-79%	77%	67%

Standard Deviation of Returns	2014	2015	2016	2017	2018	2019	U/P vs. Median Mgr. % of Periods
SHYG Capture	121%	151%	107%	135%	140%	127%	100%
SJNK Capture	135%	165%	167%	145%	152%	127%	100%

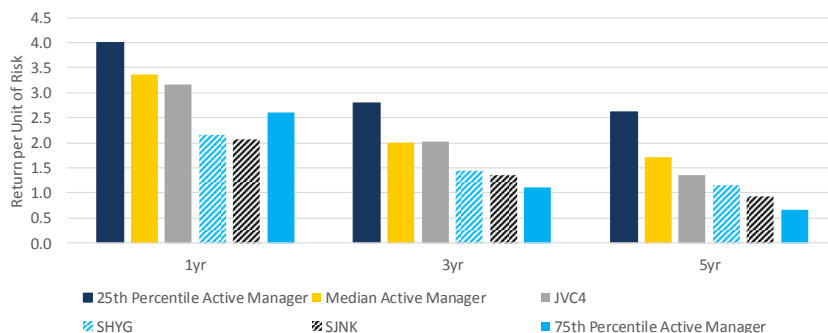
Source: SKY Harbor, ICE BofA Indices, Bloomberg, eVestment Global Database; data through June 30, 2020

Note: ETF returns are calculated on a price basis; JVC4, ETF, and manager returns and standard deviations are calculated using monthly data

Below, we compare risk-adjusted ETF returns to the index and the median active manager from our data set, and further augment our comparison to include 25th and 75th percentile active managers (gateway to top and bottom quartiles). On a rolling basis through the end of 2019, both SHYG and SJNK have provided weaker risk-adjusted returns in all periods relative to the 25th percentile and median manager in our data set. **As such, we would say that short duration high yield ETF risk-adjusted returns are in line with 3rd quartile active manager performance over the long run.**

Risk-Adjusted Returns

monthly data through December 31, 2019



Source: SKY Harbor, ICE BofA Indices, Bloomberg, eVestment Global Database; data through December 31, 2019

US Broad Market High Yield ETFs vs. the ICE BofA US High Yield Index (H0A0)

We turn our attention now to the broad market US High Yield ETFs (US HY ETFs not constrained by duration). Once again, we preface this section of our analysis with the disclosure that neither HYG nor JNK use the same benchmark as most active US high yield managers. The benchmark for HYG is the iBoxx USD Liquid High Yield Index, a market capitalization-weighted index consisting of liquid USD high yield bonds, while the benchmark for JNK is Bloomberg Barclays High Yield Very Liquid Index, an index designed to track a more liquid subset of USD-denominated high yield securities. Active high yield managers, on the other hand, typically use one of several broad high yield market indices created by ICE BofA, Barclays, JP Morgan or Citi. For this analysis, we will be using the ICE BofA US High Yield Index (H0A0), one of the most commonly used benchmarks in the active space, as a proxy for the US high yield index. Since a significant portion of the buyer base views HYG and JNK as an alternative to active high yield management exposure, we believe the comparison is a fair one to make.

Using data going back to 2008 (the first full year of broad market ETF returns available), we compare performance of the high yield ETFs to H0A0, presented below in terms of relative capture.

ICE BofA US High Yield Index (H0A0) vs. iShares iBoxx High Yield Corporate Bond ETF (HYG) and SPDR Bloomberg Barclays High Yield Bond ETF (JNK)

monthly data, since 2008

Returns	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	U/P vs. Index % of Periods
H0A0 Total Return (%)	(26.4)	57.5	15.2	4.4	15.6	7.4	2.5	(4.6)	17.5	7.5	(2.3)	14.4	
HYG Capture	67%	50%	78%	154%	75%	78%	76%	108%	77%	81%	89%	98%	75%
JNK Capture	94%	65%	93%	117%	86%	79%	31%	146%	82%	87%	145%	103%	75%

Standard Deviation of Returns	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	U/P vs. Index % of Periods
HYG Capture	117%	152%	134%	127%	166%	120%	117%	104%	81%	90%	102%	115%	83%
JNK Capture	135%	161%	139%	129%	174%	117%	128%	113%	90%	96%	108%	121%	83%

Source: SKY Harbor, ICE BofA Indices, Bloomberg

Note: ETF returns are calculated on a price basis; both H0A0 and ETF returns and standard deviations are calculated using monthly data

Return and Volatility Capture: ETFs vs. Index

monthly data through June 30, 2020

Returns	YTD	1yr	3yr	5yr	7yr	10yr
H0A0 Total Return (%)	(4.8)	(1.1)	2.9	4.6	4.8	6.5
HYG Capture	107%	135%	87%	80%	81%	88%
JNK Capture	113%	169%	78%	70%	74%	85%

Standard Deviation of Returns	YTD	1yr	3yr	5yr	7yr	10yr
HYG Capture	87%	88%	92%	92%	95%	106%
JNK Capture	95%	96%	100%	100%	103%	113%

As demonstrated above, on an annualized basis using monthly returns from the start of 2008 until the end of 2019, ETF performance has been weak relative to the ICE BofA US High Yield Index. In fact, **over the twelve-year data set shown above, HYG and JNK only outperformed the index in three periods (they underperformed 75% of the time).** Additionally, we would note that annualized standard deviation of returns for ETFs expose the buyer to

greater volatility relative to H0A0 in every year except 2016 and 2017 (i.e., ETFs are more volatile than the index 83% of the time). **In summary, we would conclude that on an annualized basis through the duration of our data set, broad market US high yield ETFs appear to pick up, on average, ~ 75% of the index return, with ~ 115% of the index volatility.**

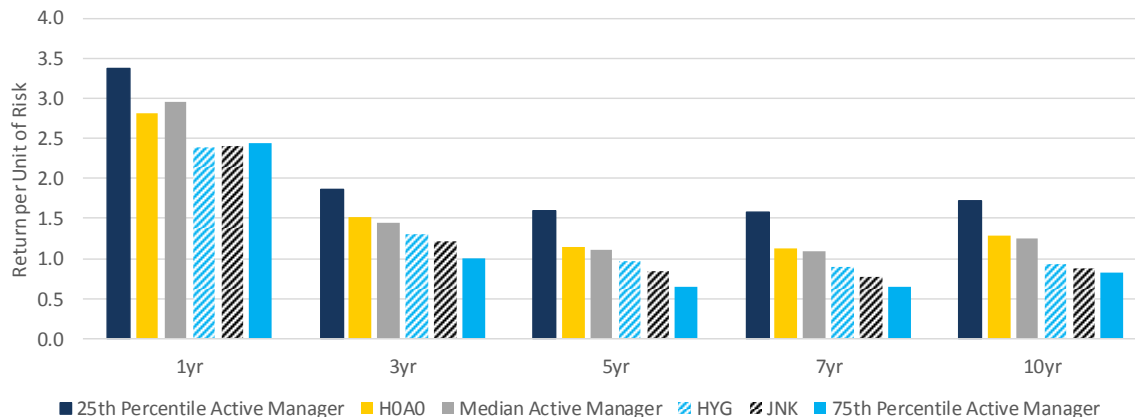
For the same reasons as cited in our short duration high yield analysis, we must again concede that this comparison is somewhat unfair given inherent advantages of indices (no management fee, no transaction costs, and an ability to gain exposure to any and all securities, even those that are illiquid and unavailable for actual purchase). Again, we attempt to level the playing field, and continue our analysis below, this time comparing broad market US high yield ETFs to active managers.

US Broad Market High Yield ETFs vs. Active Managers

As demonstrated below, both HYG and JNK have provided weaker risk-adjusted returns in all periods relative to the 25th percentile active manager (gateway to top quartile), H0A0 index, and the median active manager in our data set. **As such, we would say that high yield ETF returns are in line with 3rd quartile active manager performance over the long run, and close to 4th quartile performance on a risk-adjusted basis over the trailing 10yr period.** Also, note that active manager performance data is net of management fees, so the comparison accurately represents USD-denominated realized returns from the perspective of an investor.

Risk Adjusted Returns

monthly data through December 31, 2019



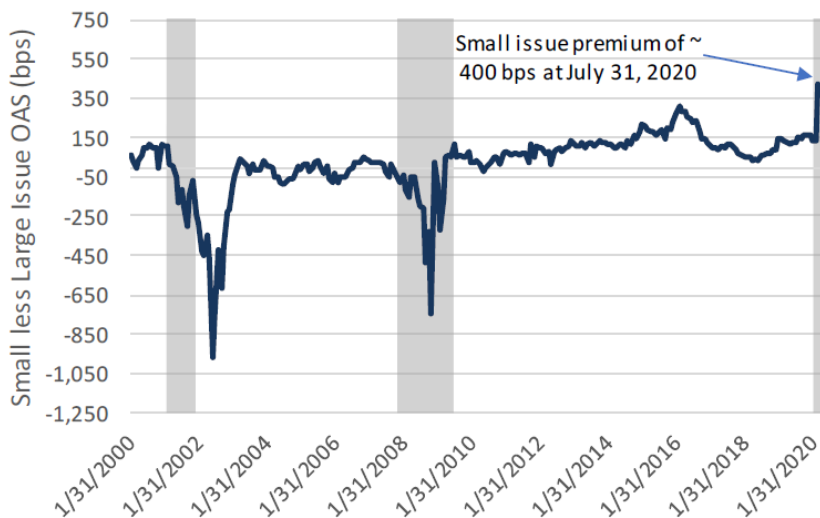
Source: SKY Harbor, ICE BofA Indices, Bloomberg, eVestment Global Database; data through December 31, 2019

SKY Harbor F.A.S.T. Process Output: Key Risks & Opportunities

SKY Harbor uses the output of our monthly FAST meeting to identify key risks and opportunities in the current market environment. While there are numerous risks on the horizon – most notably those associated with the coronavirus and looming US elections – we remain focused on what we believe are significant opportunities in the US high yield space that remain insulated from factors that investors are most concerned about. In particular, we have positioned our portfolios to benefit from the following four themes:

#1: Small Issue Premiums Appear Too Large

We continue to believe that smaller bond issues (< \$350mm in size) look attractive relative to large issues (> \$1bn in size), the former trading ~ 400 bps wide of the latter despite an opposite relationship in prior periods of stress. Even adjusting for differences in underlying credit quality, duration, and sector characteristics, we find small issue premiums to be too large. In our view, normalization of this relationship should facilitate outperformance of small issues over the intermediate term.



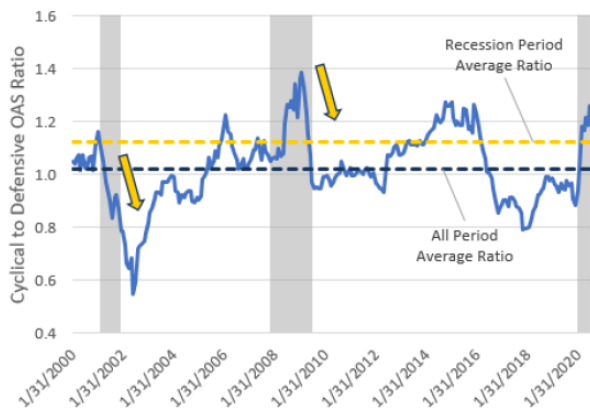
Source: SKY Harbor, ICE BofA Indices; data as of July 31, 2020

#2: Cyclical Appear Poised to Outperform

In our view, a rotation into cyclical credits is prudent given spread levels and the timing of the cycle. Historically, cyclicals tend to outperform defensives once recessionary pressures appear primed to subside. Should this line of thinking be premature (risks remain, mainly the potential for a second wave of virus-induced shutdowns), the cyclical (ex-Energy)- to-defensive OAS ratio provides some cushion. As demonstrated in the chart below and to the right, and regardless of whether or not we have hit an inflection point in recessionary conditions, next 12 month returns of cyclicals less defensives tend to be highly positive when the starting point is one in which the cyclical-to-defensive ratio is over 1.2x, which it is right now. In our view, normalization of this relationship should facilitate outperformance of cyclical issues over the intermediate term.

Cyclical (ex Energy) to Defensive OAS Ratio Yet to Compress

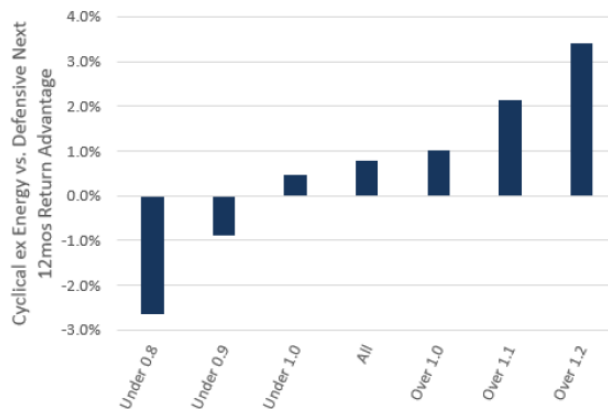
OAS ratio, recessions shaded grey



Source: SKY Harbor, ICE BofA Indices; data as of July 31, 2020

Cyc. ex Energy less Def. Returns: Next 12mos Advantage

Cyclical ex Energy OAS to Defensive OAS Ratio starting point buckets

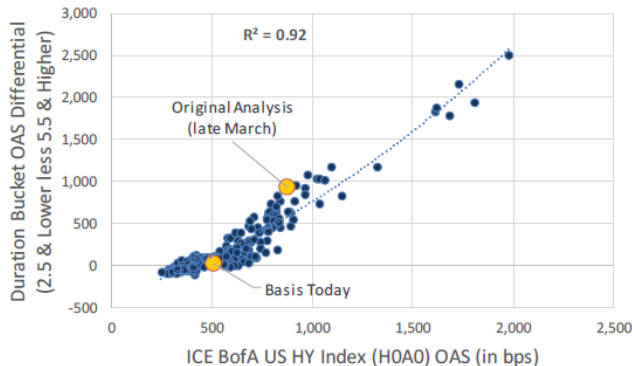


#3: The Short End of the Corporate Credit Curve Remains Too Steep

From a duration perspective, we like short duration, but not the shortest duration part of the market. Back in March (the onset of virus-induced lockdowns) corporate credit curves inverted on fears that credit markets might freeze up, thus making the duration 0-2 bucket higher yielding than longer-dated bonds. Market conditions have since normalized, and the steepest part of the curve is now the duration 2-4 bucket. In our view, a flattening of this part of the curve should facilitate outperformance of duration 2-4 constituents over the intermediate term.

Front-End Was 200 bps Too Wide, Now Fairly Valued

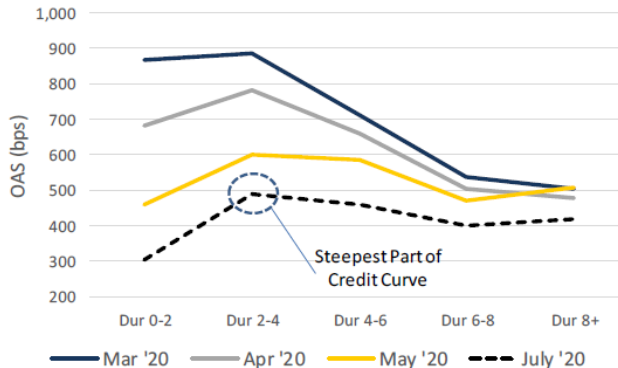
monthly data since 2000



Source: SKY Harbor, ICE BofA Indices; data as of July 31, 2020

B/BB (H0A4) Curve Has Flattened

monthly data



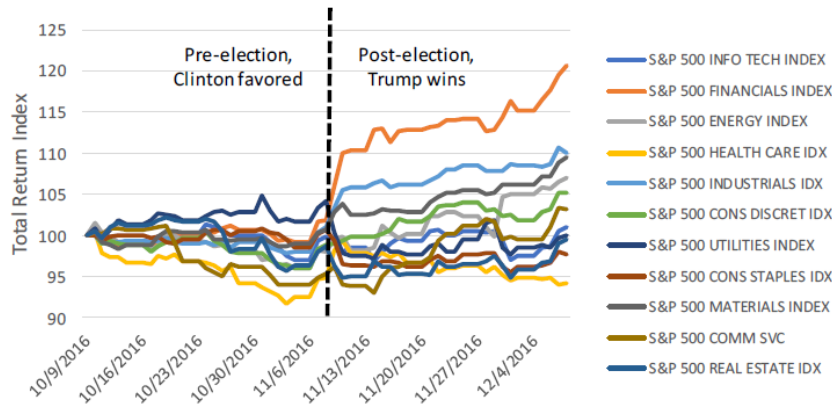
#4: The 2020 US Election Creates Uncertainty

Prediction markets and more traditional polling data point toward a Democratic advantage thus far in the presidential race, with a post-coronavirus reopening and signs of an economic recovery presumed necessities for a successful Trump re-election bid. While we do not claim to have unique insights into the 2020 election outcome, we do think it is prudent to identify potential sector winners and losers under the consensus scenario. For insights, we examined the last US presidential race. Back in 2016, former Sen. Hillary Clinton enjoyed a consistent advantage – often several points or more - over Donald Trump in polls published during the month leading up to election day. With this in mind, we can reasonably assume that most investors positioned their portfolios for a Clinton inauguration, thus necessitating an investment thesis re-set following Trump's surprise victory.

With this in mind, SKY Harbor compared S&P 500 sector performance in the month leading up to and the month immediately following the general election. After beta-adjusting sector returns relative to the S&P 500 Index, market fluctuations imply Energy, Consumer Discretionary, Financials, Industrials, and Materials as likely beneficiaries of a Trump victory, while Energy and Healthcare are likely at-risk should Biden prevail. In our view, risks associated with a Biden victory along with a Democrat-controlled Senate are not currently reflected in Energy and Healthcare spreads, the incorporation of which should lead to those sectors to underperform over the intermediate term.

US Equity Performance Around 2016 Election

daily data, indexed



Source: SKY Harbor, Standard & Poor's, Bloomberg

Beta-Adjusted Sector Implications

returns 1 month pre and post-election

Trump Victory Presumed Winners	Biden Victory Presumed Losers
Energy	Energy
Consumer Discretionary	Healthcare
Financials	
Industrials	
Materials	

Implementing Our Highest Conviction Portfolio Themes

To summarize SKY Harbor's FAST outlook, we believe overweighting small issues, cyclical credits, and bonds with a duration of 2-4 are key opportunities in the current market environment. At the same time, we see US elections as being a key risk, and favor underweighting select Energy and Healthcare sector credits that we believe are poised to experience the greatest fundamental pressure should a Democrat sweep materialize. Driven by both constraints and preferences, we find ETFs (we use HYG and JNK, the two largest, as proxies) to be poorly positioned to benefit from our highest conviction themes. As demonstrated in the chart below, **our SKY Harbor Targeted Portfolio is positioned to be overweight small issues, cyclicals, and duration 2-4 on valuation, and underweight Energy and Healthcare on under-appreciated election risks.** ETF holdings appear skewed in opposition to these themes, and in our view will fail to capture the strong risk-adjusted returns we think will materialize as our base case thesis plays out.

Exposure by Market Value (%)

columns represent SKY Harbor high-conviction themes

Exposure by Market Value	Small Issues (< \$350mm)	Cyclicals	Duration 2-4	Energy	Healthcare
SKY Harbor Targeted Portfolio	30.3	50.7	51.3	0.0	4.6
ICE BofA US High Yield Index (H0A0)	6.0	40.3	30.1	13.1	9.2
iShares iBoxx High Yield Corporate Bond ETF (HYG)	0.4	37.2	30.4	11.4	11.9
SPDR Bloomberg Barclays High Yield Bond Fund ETF (JNK)	0.0	39.3	24.0	10.5	10.7

Source: SKY Harbor, Bloomberg

Who is Best Positioned to Take Advantage of These Trends?

vs. SKY Harbor high conviction themes, green = well positioned, red = poorly positioned

Exposure by Market Value	Small Issues (< \$350mm)	Cyclicals	Duration 2-4	Energy	Healthcare
SKY Harbor Targeted Portfolio	Green	Green	Green	Green	Green
ICE BofA US High Yield Index (H0A0)	Black	Black	Black	Black	Black
iShares iBoxx High Yield Corporate Bond ETF (HYG)	Red	Red	Green	Green	Red
SPDR Bloomberg Barclays High Yield Bond Fund ETF (JNK)	Red	Red	Red	Green	Red

Summary Conclusion

- SKY Harbor's examination of US High Yield ETF performance leaves us biased toward active management; ETFs have consistently underperformed indices and have historically been 3rd or 4th quartile performers in the context of active manager risk-adjusted returns
- On an annualized basis through the time period included in our data set, we find Short Duration US High Yield ETFs (SHYG, SJNK) have captured ~ 75% of the total return of the ICE BofA 1-5yr US High Yield Constrained Index (JVC4) with ~ 105% of the volatility
- In comparison to a database of Short Duration US High Yield active managers, SHYG and SJNK have typically generated 3rd quartile risk-adjusted returns
- On an annualized basis through the time period included in our data set, we find Broad Market US High Yield ETFs (HYG, JNK) have captured ~ 75% of the total return of the ICE BofA US High Yield Index (H0A0) with ~ 115% of the volatility
- In comparison to a database of Broad Market US High Yield active managers, HYG and JNK have typically generated 3rd quartile risk-adjusted returns
- SKY Harbor's analysis suggests ETFs are poorly positioned to take advantage of the key opportunities and defend against the key risks in the market as we see them
- Key opportunities in the current market environment - as identified through SKY Harbor's F.A.S.T. process - include attractive premiums for smaller bonds, excess spread for cyclicals, and steepness in the 2-4 duration part of the corporate credit curve
- Key risks in the current market environment - as identified through SKY Harbor's F.A.S.T. process - include rising political uncertainty and the potential for sweeping reforms should the Democrats secure the presidency and both houses of Congress in the November general election; in that case, we think downside risk may emerge for many issuers in the Energy and Healthcare sectors
- SKY Harbor believes historical risk-adjusted returns make a compelling case for active management in US high yield, and we believe the ability to position portfolios to capture our highest-conviction market themes will prove beneficial over the intermediate term (and note that ETFs are unable to position in this manner).

Important Disclosures and Disclaimers

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Gross performance results do not reflect the deduction of investment advisory fees, which would reduce an investor's actual return. For example, assume that \$1 million is invested in an account with the Firm, and this account achieves a 6% compounded annualized return, gross of fees, for five years. At the end of five years that account would grow to \$1,338,226 before the deduction of management fees. Assuming management fees of 0.55% per year are deducted annually from the average annual AUM, the value of the account at the end of five years would be \$1,302,846, which is the equivalent of an annual compounded rate of 5.43%. For a ten-year period, the ending dollar values before and after fees would be \$1,790,848 and \$1,697,408, respectively. SKY Harbor's asset-based fees are generally billed monthly or quarterly in arrears. Please refer to the SKY Harbor's ADV Part 2A or applicable Offering Documents for more information on fees. Consultants supplied with gross results are to use this data in accordance with SEC, CFTC, NFA or the applicable jurisdiction's guidelines.

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