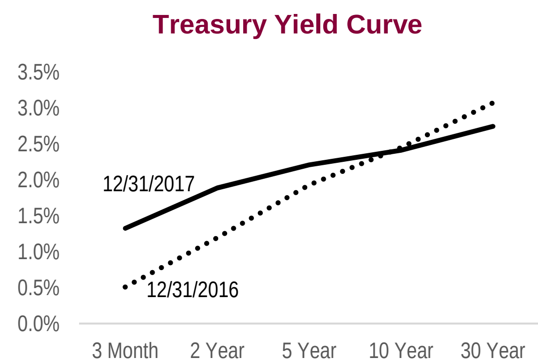
High Yield
2017 Commentary

December 31, 2017

MARKET COMMENTARY



The ICE BofAML US High Yield Index posted a positive return in each calendar quarter of 2017, finishing the year up +7.5%. The index has posted positive performance in 8 consecutive quarters. The market's yield-to-worst at year-end was 5.8%, which is 0.3% lower than it was at the beginning of the year; the market's spread over treasuries finished the year at 363 basis points, which represents a 59 basis point tightening over the course of the year (the interest rate on similar duration treasuries rose slightly). The treasury yield curve flattened over the year. The FOMC increased the Fed Funds target rate by 25 basis points three different times during 2017, moving the rate from 0.75% to 1.50% by year-end. This precipitated a comparable rise in short-term treasury rates but long-term rates actually fell slightly. We pay close attention to the yield curve because it has inverted prior to each of the past 7 recessions—while it has flattened, it remains upward sloping.

Lower rated credits led the market in 2017, with CCC & lower rated credits climbing +10.6%. BB-rated credits and single-B rated credits increased +7.2% and +6.8%, respectively. Spreads for CCC & lower rated credits tightened by 130 basis points compared to just 53 and 41 basis points for BB- and single-B rated credits, respectively. The best performing sectors were transportation, utilities, and banking; the laggards were retail, consumer goods, and media. All sectors were positive, and the difference between the best performer (transports) and the worst performer (retail) was about 11 percentage points. This is in stark contrast to calendar year 2016, when the top-performing sector (energy) outperformed the worst-performing sector (healthcare) by more than 34 percentage points.

Including distressed exchanges, the par-weighted high yield bond default rate in 2017 was 1.45%. For perspective, the default rate in 2016 was 4.26%. The primary reason for the decline in defaults was the energy sector; the sector's default rate went from 15.6% in 2016 to 2.1% in 2017. Across the market, revenue, earnings, and cash flow have grown, financial leverage has declined, liquidity has improved, and the maturities are well-termed. Fortunately, these factors have led to low defaults; unfortunately, these factors have led to tight spreads.

Despite the tightening of energy credits, we continue to overweight the sector and favor credits with strong asset coverage that are senior in the capital structure. This has helped us maintain a spread advantage of nearly 50 basis points relative to the broad market. While the market is tighter than average, fundamentals are solid and we are positioned in credits with strong/quality asset coverage. We continue to adhere to our core competency of focusing on small/mid cap credits and fallen angels, which we view as a core competitive advantage.

ATTRIBUTION: 2017

The Hotchkis & Wiley High Yield portfolio (gross and net of management fees) outperformed the ICE BofAML BB-B US High Yield Constrained Index and the broader ICE BofAML US High Yield Index in 2017. Positive credit selection drove nearly all of the outperformance for the year. While credit selection was positive or neutral in 16 of 18 sectors, it was particularly strong in basic industry, energy, and media credits. The overweight allocation to basic industry and underweight allocation to telecommunications also helped relative performance. Credit selection in retail and financial services were modest detractors in the year.

OUTLOOK (SCORING SCALE: 1=VERY NEGATIVE….5=VERY POSITIVE)

Fundamentals (4): The fundamentals score remains unchanged at 4. Financial leverage (debt/EBITDA) has declined for 5 consecutive quarters. The default rate, including distressed exchanges, is 1.5% which is well-below historical averages. Less than 1% of the market is trading at distressed levels. Market maturities are well-termed out, with little near-term refinancing pressure; less than one-fourth of the market comes due within the next four years. Perhaps most importantly, revenue, earnings, and cash flows have continued to grow.

Technicals (3): The technicals score remains at 3. The primary market remains robust, with $328 billion in new issuance—nearly two-thirds of this was used for refinancing with only 17% earmarked for acquisition/LBO financing. CCC-rated new issuance comprised 15% of the primary market, slightly below the historical median of 16%. Market liquidity has continued to improve.

Valuation (2): The valuation score remains at 2. The market's yield-to-worst is 5.8% and spreads over treasuries stand at 363 basis points—a tight market. Excess spreads, or spreads adjusted for unrecovered defaults, stand at 228 basis points which is only about 60 basis points tighter than the 30-year average. In other words, strong fundamentals are supporting the above-average valuations.

Unless otherwise noted, the high yield market or "broad" index refers to the ICE BofAML US High Yield Index. The ICE BofAML Indices were known as the BofA Merrill Lynch Indices prior to October 23, 2017.

Composite performance is available at www.hwcm.com, located on the strategy's Performance tab. Returns discussed can differ from actual portfolio returns due to guideline restrictions, cash flow, tax and other relevant considerations. Portfolio attribution is based on a representative High Yield portfolio. The performance attribution is an analysis of the portfolio's return relative to the ICE BofAML BB-B US High Yield Constrained Index and is calculated using trade information and does not reflect cash flow transactions and the payment of transaction costs, fees and expenses. Absolute performance for the portfolio may reflect different results. No assurance is made that any securities identified, or all investment decisions by H&W were or will be profitable. Quarterly characteristics and portfolio holdings are available at www.hwcm.com, located on the strategy's Characteristics and Literature tabs. Portfolio information is subject to the firm's portfolio holdings disclosure policy.

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