High Yield
3Q 2017 Commentary

Hotchkis & Wiley

September 30, 2017

MARKET COMMENTARY

The ICE BofAML US High Yield Index returned +2.0% in the third quarter of 2017 and is now up +7.0% year-to-date. This marks the 7th consecutive positive quarter for the high yield market. The good news is that the market is healthy. Revenue and profits are up, defaults are down, financial leverage is moderate, and the new issue market has been reasonably well-behaved. The bad news is that much of this good news is reflected in the market's valuation. The yield-to-worst fell and spreads tightened by about 20 basis points each and now stand at 5.5% and 355 basis points, respectively. The tightening was consistent across ratings during the quarter, and small cap credits tightened slightly more than large cap credits. Treasury yields were largely unchanged.

The energy sector, which was the largest laggard in the previous quarter, was the top-performing high yield sector by a considerable margin. WTI crude prices rose by 12% over the quarter. Utilities, services, and basic industry credits also performed well, while telecom and retail lagged—though all sectors were positive.

Excess spreads, or spreads adjusted for unrecovered defaults, are below long term averages but only slightly so. This is due to low defaults as opposed to wide spreads, of course. Across the entire high yield market, there was only one default in July (True Religion Apparel), no defaults in August, and one default in September (Toys R Us). This was the first time in more than 5 years when one or fewer defaults occurred in three consecutive months. The high yield market's default rate declined to 1.3%, well below long-term averages, and less than 1% of the market is priced as distressed. Energy sector defaults had been elevated until recently, but most of the sector's cleansing appears to be in the rear view mirror. Commodity spreads have tightened accordingly, and are now only about 50 basis points wider than the overall market.

While the high yield market's valuation is not exciting, pockets of opportunities remain for diligent bottom-up credit pickers. Our focus on small and mid cap credits along with fallen angels has helped us construct a portfolio with a spread advantage relative to the broad market and BB-B indexes. This is a core competency that we view as advantageous in all environments, including those when spreads are tight and narrowly distributed; it distinguishes us from the index and our peers.

ATTRIBUTION: 3Q 2017

The Hotchkis & Wiley High Yield portfolio (gross and net of management fees) performed similarly to the ICE BofAML BB-B US High Yield Constrained Index and ICE BofAML US High Yield Index; underperformed net of fees. The overweight allocation to energy and underweight allocation to telecom was favorable to relative quarter performance. Energy was the best-performing high yield sector, by far. Positive credit selection in healthcare, utilities, and media also helped. On the negative side, credit selection in basic industry, telecom, and services detracted from performance.

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

Fundamentals (4): The fundamentals score remains unchanged at 4. Revenue grew by 6% and EBITDA grew by 8% over the prior year, reflective of Corporate America's overall health. The default rate continued to fall, and is now a mere 1.3% including distressed exchanges. Less than 1% of the market is priced as distressed (<50% of par). Leverage has declined and remains well within typical levels. The high yield market is well-termed with little near-term refinancing pressures.

Valuation (2): We maintained the valuation score at 2. The yield-to-worst declined and spreads narrowed, both by about 0.2% during the quarter. At 5.5% and 355 basis points, respectively, the market has been more attractively valued before. Strong fundamentals support the higher valuations.

Technicals (3): The technicals score remains unchanged at 3. The new issue calendar is robust and appears to be loosening slightly. Flows have been moderate. Low rated new issuance increased from a 12 year low to average levels. Liquidity across the market has improved over the past year, as bond dealers have increased inventory levels. Also, rating agency upgrades continue to outpace downgrades.

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 US High Yield 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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