

Manager Review & Economic Outlook

MARKET COMMENTARY

The ICE BofAML US High Yield Index returned +7.4% in the first quarter of 2019. This was its best calendar quarter since immediately following the great recession's low point when the index returned +23% and +15% in back-to-back quarters (2Q and 3Q of 2009, respectively). During the first quarter of 2019, high yield credits outperformed investment grade credits. Within high yield, performance dispersion was wide when assessing the market by either credit size or by sector, though it was relatively narrow when contrasting by credit rating. Large cap credits outperformed small cap credits by about 1.4% in the quarter, a considerable margin and a headwind for our focus on small and mid cap credits. All sectors were positive, with energy, retail, and financial services each returning more than 8%. Transportation, autos, and telecom lagged, returning +3.2%, +5.5%, and +5.9%, respectively. CCC rated bonds narrowly outperformed the overall market, while BB and B rated bonds performed similarly.

After four rate hikes in 2018, the Fed not only took a hiatus but offered rather dovish comments, triggering a modest rally in treasuries. Yields on the 2-, 5-, 10-, and 30-year treasuries fell between 20 and 30 basis points, with the larger decline coming from the middle of the yield curve. The yield curve actually inverted slightly on the short end, with the 2-year yield slightly exceeding the 5-year yield at quarter end (2.26% vs. 2.23%). Beyond the 5-year note the yield curve remains positively sloped, albeit slightly so. High yield spreads over treasuries narrowed by 127 basis points, ending the quarter at 405 basis points. Yields on equivalent-duration treasuries fell 0.2%, thus the yield-to-worst on the high yield market declined by 1.47%, ending the quarter at 6.5%. Spreads narrowed and yields fell disproportionately for lower rated credits and also for large cap credits—this decreased the spread/yield advantage of lower rated credits relative to higher rated credits and increased the spread/yield advantage of small and mid cap credits relative to large cap credits.

The trailing 12-month high yield default rate, including distressed exchanges, fell from 1.87% at the beginning of the year to 1.02% at the end of the quarter. Most of the decline, however, was due to the large iHeart default in the first quarter of 2018 rolling out of the calculation. There were 7 high yield bond defaults and 1 distressed exchange during the first quarter, totaling slightly more than \$6 billion in total par value (the total market is more than \$1.5 trillion). Recovery rates were just over 40%, right in line with historical averages. The low default environment is supported by a market that has demonstrated continued revenue and earnings

growth. The market exhibits its lowest leverage levels in 6 years (debt/EBITDA) and highest interest coverage in 8 years ([EBITDA-Capex] / interest expense). While spreads are low, spreads per unit of leverage are above average.

The primary market has outpaced last years' sluggishness but remains relatively subdued compared to years prior to 2018. Less than 10% of this year's new issuance was CCC rated, the lowest level in at least 15 years; 80% of this was used for refinancing, the highest level in at least 20 years. There were more ratings downgrades than upgrades in the quarter, but by par value there were more upgrades than downgrades (the upgrades were larger bonds). Distressed debt comprises a negligible portion of the overall market: just 3.4% of the market trades at less than 70% of par value and just 1.2% trades at less than 50%.

The overall market remains quite healthy and well-behaved, though this condition is reflected in valuations. Our focus on small and mid cap credits facilitates a considerable spread advantage relative to our benchmarks, and in our view, without assuming disproportionate credit risk. As a result, we are optimistic regarding the portfolio's prospects relative to the market as we look forward.

ATTRIBUTION

The Hotchkis & Wiley High Yield portfolio (gross and net of management fees) underperformed the ICE BofAML US High Yield Index and ICE BofAML BB-B US High Yield Constrained Index in the first quarter. Relative to the broad benchmark, the portfolio is overweight single B credits while underweight both BB and CCC credits; this positioning had a negligible impact on relative performance in the quarter. The emphasis on small and mid cap credits was a headwind in the quarter, as it was in calendar year 2018. We are optimistic this headwind will transform into a tailwind, particularly given the increased small/mid cap spread/yield advantage that has developed. Beyond the small/mid cap effect, credit selection in energy, basic industry, and consumer goods detracted from relative performance. Positive credit selection in healthcare and an underweight allocation to telecommunications helped relative performance.

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

Fundamentals (3)

No change. Defaults remain well below average. We expect a benign environment to continue because leverage remains in check and because revenue and earnings are healthy. Trade war potential keeps the score from rising further, which has the potential to impede economic growth and therefore affect revenue and earnings growth.

Technicals (3)

No change. The new issue market remains relative soft but has picked up from last year's pace. New issuance has been largely for refinancing with LBO issuance relatively contained. While overall market liquidity remains decent, the asset class has experienced considerable outflows.

Valuation (3)

No change. While yields fell and spreads narrowed, valuation remains appropriate considering the market's decreased leverage and overall health. The excess spread, or spread adjusted for unrecovered defaults, remains stable.

Unless otherwise noted, the "high yield" or "broad" market refers to the ICE BofAML US High Yield Index

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 characteristics and attribution based on 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 holdings, or all investment decisions by H&W were or will be profitable. The High Yield strategy may prevent or limit investment in major bonds in the ICE BofAML US High Yield Index and ICE BofAML BB-B US High Yield Constrained indices and returns may not be correlated to the indices. 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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