High Yield
1Q 2017 Commentary

Hotchkis & Wiley

March 31, 2017

MARKET COMMENTARY

The BofA Merrill Lynch US High Yield Index returned +2.7% in the first quarter of 2017. The yield-to-worst fell and spreads tightened, each by about 30 basis points in the quarter; similar duration Treasury yields were essentially unchanged. Lower rated bonds performed best, which is typical in strong positive markets. The CCC-rated portion of the index returned +5.2% and CCC spreads tightened by more than 100 basis points. The top performing sectors, in order, were transportation, healthcare, telecommunications, and utilities. Retail was the lone negative sector, though it declined by less than one percentage point.

The market ended the quarter with a yield-to-worst of 5.9% and spread over treasuries of 391 basis points. With spreads both tight and narrowly distributed, it is not the most compelling environment we have ever observed based on valuations alone. Nonetheless, high yield valuations appear more attractive than fixed income alternatives, even after adjusting for differences in risk. Strong market fundamentals are the primary cause of the tight high yield market. The trailing 12 month default rate has fallen well below average (~2.5%), and is poised to decline further as early-to-mid 2016 defaults roll off. Defaults outside the commodity sectors have been nearly non-existent, persisting at less 1% over the past year. Default increases are most often preceded by revenue and margin declines coupled with increases in financial leverage. Revenues and margins have recently improved; however, and leverage has come down.

We have been able to identify attractive individual opportunities, though it is more difficult than in years past. Our penchant for small and mid cap issuers expands our investable universe beyond what is accessible to our largest peers and ETF investors. Such investors are limited to only the most liquid high yield credits, and are compelled to overlook an important segment of the high yield market where opportunities abound. In the current environment, we have identified the most attractive risk-adjusted opportunities in basic industry, energy, and consumer goods credits. Our exposures are predicated on our bottom-up analysis of the individual credits, many of which are misunderstood or ignored by the largest high yield investors. We believe this approach is a considerable advantage in all markets, but disproportionately so in environments where obvious opportunities are hard to find. The portfolio maintains a notable spread advantage relative to the market without assuming undue risk. Going forward, we will maintain our commitment to this time-tested approach and are optimistic about the long-term risk/return prospects of the portfolio.

ATTRIBUTION: 1Q 2017

The Hotchkis & Wiley High Yield portfolio (gross and net of management fees) outperformed both the broad high yield index[1] and the BB-B index[2] in the quarter. There were no notable themes in terms of quality, size, etc. Our bottom-up credit research worked as designed. Positive credit selection drove all of the outperformance. While consumer goods, media, and energy were particularly strong, the positive credit selection was broadly distributed. In fact, credit selection was positive or neutral in 16 of the 18 Merrill Lynch sectors. The two negative sectors had a combined effect of -7 basis points. The largest performance detractor was the underweight exposure to telecommunications, which was among the best performing sectors in the quarter.

[1]BofA Merrill Lynch US High Yield Index
[2]BofA Merrill Lynch BB-B US High Yield Constrained Index

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

Fundamentals (4): We increased the fundamentals score from 3 to 4. Revenue growth turned positive and margins have improved, which significantly reduces default risk. The default rate, including distressed exchanges, fell to 2.5%. Excluding commodity sectors the default rate is a benign 0.6%. Leverage has declined and interest coverage has improved. The maturity calendar is well termed; there is no near-term maturity wall that would pressure refinancing. The dollar has been strong which poses a challenge to businesses that generate revenue outside US borders.

Valuation (2): We maintained the valuation score at 2. The yield-to-worst declined to 5.9% and spreads narrowed to 391 basis points—a tight market. Valuations look more reasonable after adjusting for the low default rate environment. Excess spreads are only moderately below historical levels. The narrowing has been led by commodity sectors, which are only slightly wider than the market average. Other fixed income categories exhibit valuations considerably worse, both in absolute and relative terms.

Technicals (3): We decreased the technicals score from 4 to 3. The new issue calendar is robust and appears to be loosening slightly. 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 outpace downgrades for the first time in nearly 2 years.

Unless otherwise noted, the high yield market refers to the BofA Merrill Lynch 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 attribution is based on a representative High Yield portfolio. The performance attribution is an analysis of the portfolio's return relative to the BofA Merrill Lynch 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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