Hotchkis & Wiley
High Yield Webinar Replay

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Hotchkis & Wiley

Assessing the High Yield Market: Prospects for the Rest of the Year

Listen in on a recent conference call featuring Portfolio Manager Mark Hudoff as he provides an update on the high yield strategy and shares his thoughts on Market Outlook - Fundamentals, Technicals and Valuation

Audio Replay **Presentation**

Hotchkis & Wiley High Yield Fund - Average Annual Returns as of March 31, 2019

	1Q19	1 Year	3 Year	5 Year	10 Year	Since 3/31/09
I Shares (net of fees)	6.01%	3.02%	8.10%	3.86%	9.96%	9.96%
I Shares (gross of fees)	6.19	3.76	8.87	4.60	10.74	10.74
ICE BofAML BB-B US HY Constr. Index	7.34	6.33	7.75	4.74	10.09	10.09
ICE BofAML US High Yield Index	7.40	5.94	8.69	4.70	11.24	11.24

The Fund's total annual operating gross expense ratio as of the most current prospectus is 0.74% for I Shares; net expense ratio is 0.70%. The Advisor has contractually agreed to waive advisory fees and/or reimburse expenses through August 29, 2019. 30-Day SEC Yield with Expense Waiver: 6.69%; 30-Day SEC Yield w/o Expense Waiver: 6.65%. *The performance shown represents past performance. Past performance is no guarantee of future results and current performance may be higher or lower than the performance shown. Investment results and principal value will fluctuate so that shares, when redeemed, may be worth more or less than their original cost. To obtain performance data current to the most recent month-end, access our website at www.hwcm.com.*

Transcript

Operator: Greetings. Welcome to the Hotchkis & Wiley First Quarter High Yield Call for Investment Professionals. At this time all participants are in a listen only mode. If anyone should require operator assistance during the conference, please press *0 on your telephone keypad. Please note this conference is being recorded. I will now turn the conference over to your host, Mary Papamarkou, Managing Director. Ms. Papamarkou, you may begin.

Mary Papamarkou: Good afternoon everyone. Thank you, operator. This is Mary Papamarkou and I'm joined here today with Mark Hudoff, Portfolio Manager, and on behalf of everyone at Hotchkis & Wiley, thank you for joining us today. Today we will be conducting review of the portfolio performance and positioning with a discussion on our 2019 market outlook. All lines have been muted, but please feel free to submit questions to the chat function at any time, and we'll do our best to answer as we go along.

Some key updates about our firm and the high yield strategy as of March 31, 2019, our firm's assets totaled approximately $30.4 billion. The high yield strategy had approximately $4 billion in total assets, of which approximately $2.6 billion are in the fund and the remainder in separate institutional accounts. Let's meet our High Yield Team; this is our new slide. I will mention that we did have one addition to our research team, Anthony Philipp joined us several weeks ago as an analyst covering the consumer discretionary space. So, let's go ahead and get the webinar started.

Mark Hudoff: Okay, thanks everyone. I'm going to go through this relatively quickly. If you go to, turn to Page 3, you can see performance, frankly, a little disappointing. After the fourth quarter's drama and turmoil the first weeks of January, turned into, or turned around pretty dramatically. We saw very aggressive rally in the first two months of the year, trailing off into March. But nonetheless, a big disparity in returns. Really the theme was, I think, driven by the technicals more than anything else.

You had a policy toggle that took place with the Fed going from signaling continued tightening to going on hold. That happened at the same time that effectively you started to see flows coming back into the market that started in early January. A stunning amount of ETF formation, nearly $13 billion of AMG inflows, and at the same time, have very weak technical issuance. No fallen angels coming into the market, in fact, rising credit quality, you had fund coupons still having to get put to work in the market and supply contraction in the form of calls, tenders and maturity.

So, a very, very strong technical picture, at the same time, the financials moving from uncertainty in the fourth quarter to, well, maybe just disconnect between Fed policy and maybe slowing economy with realization that the Fed was going to be on hold. Those first discussions coming out of Powell set the tone for the rally. Bottom line is with all that money flowing into the market, contraction of the underlying market, large caps outperformed very strongly in the quarter, and so, for the quarter we're down about 115 basis points in the fund versus the BB-B index. Like I said, that was kind of disappointing.

If you go to the next Page, you can see some of the characteristics of that effect at a credit quality level. Some drag from the investment grade side, even though we were short BBs relative to the index by nearly 17 points, there's still a little bit of positive there, in terms of returns. Really, the bulk of the underperformance in, and the small cap market underperformed the large cap market by, on the order of 50 to 75 basis points. It's a material underperformance in the first quarter.

And a lot of the underperformance we saw in the single B category of this attribution chart emanates from their because most of our holdings, you can see over on the left-hand side, a good 12 and change percent overweight in B's versus the broad index. Yeah, CCC's were a little bit of a drag. And the non-rated, really the non-rated was a bucket that didn't move in the first quarter. And that's where the underperformance, it wasn't that it was going down, it just wasn't going up with the rest of the marketplace.

I would say that we did have a new fallen angel, that we are calling a fallen angel that entered into the portfolio in the fourth quarter. And we saw a pretty strong performance out of it the first quarter, that's GE, combination of 5% perpetuals and the 2044 long bonds. And that added about 10 basis points net results to the portfolio.

If you turn the page to Page 5 you can see that, on a sector level, some of the winners in the portfolio. In the healthcare space, Community Health did very well. There was also some cats and dogs in Pharma that did okay, but that had a positive effect on the overall portfolio. You can see the short position that we have in Telecom, actually turned out to be a pretty good position in the portfolio. On the negative side, energy, you can see the average weight, a little over about just under 1%, and really at 4.5% returns for that segment of the portfolio versus 8.3%. Really in the broader high yield market, there's four segments within that energy component. E&P lagged, some of the midstream refiners did okay and services was sideways. We have an overweight in services, particularly drillers, not a huge outperformance there. We have basically a five to slightly overweight in the E&P side, again, not a big outperformer.

We keep looking at those positions, though, that's an area that we think will be able to mine for value going forward. So, we're not entirely distressed by the results in the first quarter. We think some of that is a real bifurcation in investor appetite. Natural gas, little bit levered and far away from Henry Hub seems to be sold and not have a very natural bidder right now. And so, naturally underperformed in the quarter, at least under those circumstances. Lower levered closer to Henry Hub, those kinds of credits actually traded a lot closer in line with the commodity then did the small cap names.

And so, this was probably an area where the difference between performance in small caps and large caps was most apparent. We did have a little bit of some weakness in some of the basic industry credit. Again, that was a compilation of names, some just not carrying enough water. You can see the returns were not too different, a little over 6% in our segment returns. But a heavy overweight versus 640--I mean, 760 in the broader index.

I think that, if you turn to the next slide, Page 6, we can look at the overweights and underweights. You can see that not a ton of things have gone on there in terms of the quarter. We added--we've exited to some of the positions that either run their course or we got refinanced out of them. And then we were adding some of the new calendar items, not really materially moving any of the weights around in the portfolio. We are starting to see some of that in this quarter. Average coupons still above, over on the right-hand side, above the index. Carrying the yield-to-worst premium, although, if we adjust for some nonperforming credit in there that yield-to-worst is a little lower than 7.1%, close to 7% versus the BB-B index, definitely a spread premia and discount in dollar price.

You can see in the allocation down at the bottom, really thematically, I guess we'll get into this at the end, but thematically we've been trying to take money off the table in the form of yield-to-call, harvest the yield-to-call paper, and trying to take advantage of some of these small cap names that have been underperforming and redeploy out the curve into those names. We've also seen some opportunities in sectors that, here, we really haven't been overly aggressive in. But in the fourth quarter, and particularly, the first quarter, bank debt comes to mind as a name that a, as a segment, that really start to look interesting.

Mary: So, before we move on to the next page, I'm going to start off with your bank loan question or the increased allocation there. What are your thoughts on that space? What looks attractive? What are you staying away from?

Mark: Well, there was a hiccup in the fourth quarter and into the very beginning of the first quarter in the bank debt market. You've seen the landscape there changed pretty dramatically, covenant light packages slowed down. CLO formation slowed down. Effectively, the bank debt machine that had been responsible for the growth in the bank debt market over the past several years got really, ground to a halt in the fourth quarter and into the first quarter. And that created some drama, the fund flows in that space were also not even close to what we saw, particularly in the first quarter, in the bond market.

And so, you have very weak technicals in the bank debt market. And it ended up with price structure and coupon that made it look attractive. In fact, we tracked the spreads on bank debts versus bonds, and from our perspective, bank debt looks about as attractive as it has in a long time versus bonds. And so, right, to answer your question, Mary, with the Fed on hold, at least into the medium-term, or this year say. And so what basically is stable LIBOR crediting rate, and arguably, marginally improved credit packages, may be a little bit of a discount, and LIBOR plus 350, LIBOR plus 400 kind of single B credit in a secured format, you're actually very competitive with straight bonds. And so, it's a nice opportunity. And that's where we took it up.

Mary: And then can you anticipate that you will go much higher than that positioning? Or is that about the cap weight?

Mark: Well, it's hard to say. We'll probably continue to kind of bang around on bank debts for now. This is not what we think will be the real deal in terms of the bank debt opportunity. We think that that's going to be, when we get into a real hard slogging on the economy, and we don't see that this year or next year into the immediate future or even medium-term. So, we're going to have to wait until we really get a macro slowdown, threatening recession, even recession. But then we think that's going to be the time when you would see us pushing the envelope on bank debt weight as far as we could within the reason of our fund guidelines, and so, maybe pushing towards 10%. But right now, I think we'll continue to look at, if I look at yield-to-call paper versus bank debt, I think I like the bank debt better now than the yield-to-call paper.

Mary: Great. Let's move to the other side, the left side of this page here. The position in energy has come down.

Mark: Right.

Mary: What is that space looking at? What is the composition of what that holding looks like?

Mark: Well, I mentioned it's really four segments. So, you have midstream businesses, we really don't have a ton of overweight there, you have a small, relatively small refining space, we have a couple positions in that, so, we're kind of neutral-ish in the refining space. In the E&P space, we're skewed towards smaller capitalization E&P, kind of split evenly between natural gas and oily names. The natural gas names have really been--performed very disappointingly. Some of that's just pricing of the commodity. The other side of that is that, the distance between Henry Hub and our holdings is pretty far.

And so, these guys are much more susceptible to offtake interruptions and problems and that's really a new development in that space and I think it guards a lot of the activity there. The other thing is--so, to answer the question on E&P, we're kind of neutral, we've been bringing that down. And then we are overweight in the Services and Drillers, not in the basic commodity servicers where you are going out to a lease and driving around in a truck, we're talking about deep-water drillers that have surface fleets that are best in class and that kind of thing. We think that the demand profile for those things is coming back. And we think that they're really going to benefit over the medium-term. But they basically have lagged in the first quarter, almost uniformly, except for the midstream stuff.

Mary: Great. Let's move forward and talk a little bit about what to expect on the asset class.

Mark: Well, you know we thought that this was a good time. The last six months have been kind of bumpy on a performance basis and, I think that certainly, we could have done a better job in some of our sizing decisions, and maybe anticipated a little better in some of the credit picks, particularly, in the smaller cap energy space. But we think most of that will come back. But the real point of it is, if you look at the three-year versus the five-year annual rolling annualized return, so each observation represents basically a month of three-year returns on an annualized basis or five year on an annualized basis, the 45-degree angle is basically intended to show above index performance and below index performance. And you can see, I think, that there will be short periods of time where our strategy tends to underperform. And, we get kind of sideways in these periods. But over the longer period of time, when you stretch out those--the dot observations and pull in more data, we get pretty consistent outperformance. And if you go to seven years, it's even more dramatic, there's just fewer dots.

So, that's really the point there. I think that there is some observations to say about really dramatic rallies, I think that we are going to lag in a really dramatic rally. We've seen that in '16. We saw it in '12. And we're seeing it in '19. But I think that there is a staying power associated with the strategy in this approach and it proves itself out over a longer horizon.

Mary: Great. So, we're going to move to the market outlook and this is the first time in quite some time we've seen threes across the board.

Mark: Well, and let's not make this any more dramatic than it is. It is interesting and I will tell you that we had a lot of debate about this because the fundamentals in the U.S. economy, I don't--it's a Goldilocksy kind of environment, it's an overtired statement, but it is true. Economy is operating in pretty good space, and pricing pressure has not really picked up, fourth quarter inflation protection, Market shows that and then the Fed responded to that, it was a very responsive cause-and-effect that you like to see, and the kind of cause-and-effect activity that is unlikely to produce a policy mistake.

So, pretty good policy stance, pretty good fundamentals from a growth point of view, defaults, very hard to find a threat to underlying credit in this market. You also see that where, this is a little bit more of a technical, but the real technical is flows in the first quarter, but--so, let me talk about the broader technical considerations. There's all this fear out there of BBB overhang and things like that and it's actually starting to gate behavior of investment grade companies, they're starting to tie compensation to leverage, these are things that are really motivating behavior in that space.

We're not seeing fallen angels, we're seeing, actually, rising angels, if you will, or rising stars. So actually, there's a shrinking BB space in our marketplace. CCC's have seen a lot of these legacy LBOs finally get flushed out and worked out. Not a lot of LBO activity. Not a lot of CCC activity. So, broadly speaking the bottom end of the market is also relatively constrained.

And so, you have basically some standard technicals that really dominate the Market aside from these bigger trends. And in the first quarter, I already mentioned it, the stunning inflows that we saw in ETFs and AMG really was the story of the technical backdrop because you have all these flows coming into the funds. People have to put the money to work, and we're talking $45 billion in ETFs, and we're talking, something around $13 or $14 billion in AMG inflows; that's a huge number. And when you put it against the backdrop of new issue flow, I mean we only had $65 billion in new issues in the first quarter, which is a very tepid rate.

You had calls and tenders on the order of $41 billion. So the net new issues was $24 billion, which is a very modest number. And then, like I said, the upgrade is $22 billion. So, we had observable supply of about $3 billion. And you compare that with about $18 billion of coupon reinvestment, all this net fund flow, on the order of--something on the order of $58 billion. It just was a huge supply-demand imbalance. And we think that the technicals, from our perspective, we sit stable in disequilibrium, you don't see a $45 billion ETF inflow every day.

In fact, if you look at a long chart, you'll see that it, on an annual basis, that would be a big number. And so, in the first quarter it's kind of a look back data because you don't know what it is until you see it. But our perspective was we didn't make the technicals a four, and there was a bunch of debate about that or very strongly supported, is that we just couldn't believe that the fund flows remained as consistent as they were in the first quarter. So, maybe a little bit of slowdown in that regard.

Valuation, it's all about risk-adjusted valuations. If we tick off the level versus defaults you can see that certainly spreads are below long-term averages, but if you look at them on a default adjusted basis, they're pretty close to the long-term average, especially given the outlook for relatively low and stable default rates. If you look at small caps versus large caps, large caps look like they've really run, small caps look like they've lagged. It looks like small caps are cheap.

If you look at bank debt versus bonds, bank debt looks very cheap relative to bonds right now. So, there's things to do in the valuation space and we think it merits pretty much a down the fairway view of high yield into 2019.

Mary: So, I'm going to tip back to technicals real quick for a second. And given your discussion on technicals and some of what's happening there, do you expect that because of the situation there that we'll see the new issue calendar keep that slower pace?

Mark: You know you don't have the typical sources...the defeasance of fl… The answer is, yes, I think it's going to be a very tepid calendar this year. I think that the bank debt market probably starts to come back marching forward. That happens probably in, as we move into the second half of the year. So, that's going to suck supply away from the bond market. The original, I mean, the original bad actors, and they are not bad people, but they create drama, LBO sponsors, guys like that, they're just not involved in high yield. In fact, if you look at the percentage of LBO paper that's in the bank debt market versus the bond market, I mean, it's less than 10% of the bond market is LBO sponsored deals. It's a much higher percentage in the bank debt market.

So, the bank debt--the LBO guys are using bank debt as their instrument not the bond market. And so, we don't have a buildup in the typical kind of high leverage mischief that we have in the past. So, that won't be a source of supply either.

Mary: I guess in the secondary supply situation, are you seeing more bonds being called?

Mark: That's another issue. As everyone was talking last year about the Fed continued to march higher with rates, corporate treasurers were thought to be kind of panicking about trying to get out and term out debt. That certainly slowed when the Fed went on hold. But we are indeed seeing, particularly vintages that have more owners covenant packages and things like that, we are seeing a pretty big pick up in--it's that the issue is not followed with--it's either termed into bank debt or it's just using cash to amortize bonds or it's some other use that's not materializing back in the bond market. And so, the answer is yeah, we are not seeing new issuance emanating from our side. In fact, it's declining.

Mary: So, with that, that's all the questions we had. Any additional comments to circle out the call and then will say thank you to everyone for joining us.

Mark: Well, thanks everyone. I look forward to talking to you again. And we wish everyone good luck in 2019.

Mary: Great. Well thank you everyone for interest in the Hotchkis & Wiley strategy. Thank you for participating on today's webinar and have a great day.

Operator: This concludes today's conference. You may disconnect your lines at this time. Thank you for your participation.

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