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Hotchkis & Wiley
High Yield Webinar Replay

Hotchkis & Wiley

Why High Yield Bonds Deserve A Strategic Allocation

Listen in to a recent conference call featuring Portfolio Manager Ray Kennedy as he discusses the current high yield landscape and the case for a strategic allocation to this asset class.

Audio Replay **Presentation**

Hotchkis & Wiley High Yield Fund - Average Annual Returns as of September 30, 2017

	Class I	Class A	(w/ sales charge) Class A	Class C	(w/ cdsc) Class C	BofAML BB-B US HY Constrained Index
1 Year	9.56%	9.31%	5.23%	8.47%	7.47%	7.91%
3 Year	5.33	5.06	3.73	4.31	4.31	5.79
5 Year	6.27	6.01	5.20	5.20	5.20	6.15
Since 3/31/09	11.38	11.01	10.51	10.26	10.26	11.26

The Fund's total annual operating gross expense ratio as of the most current prospectus is 0.74% for I Shares, 0.99% for A Shares and 1.74% for C Shares. The net expense ratio is 0.70% for I Shares, 0.95% for A Shares and 1.70% for C Shares. The Advisor has contractually agreed to waive advisory fees and/or reimburse expenses through October 31, 2018. *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 and welcome to the Hotchkis & Wiley Second Quarter 2017 High Yield Webinar for Investment Professionals. At this time, all participants are in a listen-only mode. An interactive question-and-answer session will follow the formal presentation. If anyone should require Operator assistance during the conference, please press star, zero on your telephone keypad. As a reminder, this conference is being recorded. I'd now like to turn the conference over to your host, Ms. Mary Papamarkou. Thank you. You may begin.

Mary Papamarkou: Thank you Matt. Good afternoon everyone and welcome to our high yield strategy webinar/call for investment professionals. My name is Mary Papamarkou, Managing Director of Mutual Fund Distribution and today I'm joined by Ray Kennedy, Portfolio Manager. On behalf of everyone at Hotchkis & Wiley, thank you for joining us today. We will be conducting a review of the Hotchkis & Wiley high yield strategy, our second quarter performance, market outlook and strategy positioning. We will also spend some time talking about what has—why what has happened in the past market cycles may not be predictive of what will happen in the current market environment. All lines have been muted for today's call, 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. We will take Operator assisted calls — questions at the end of the call.

Some key updates about our firm and the high yield strategy: Earlier this year, the team was one of the finalists for Morningstar's Fixed Income Manager of the Year; this is the second time that Ray and Mark have been nominated since they've joined Hotchkis & Wiley and so we're very proud of that recognition. As of June 30th, our firm assets totaled a little over $30 billion, the high yield strategy had approximately $3.9 billion in total assets, of which $2.7 billion are in the fund and the remainder in separate institutional accounts. So with that, let's get started. I'll do a quick background of our team before turning the call over to Ray.

As you are aware, the research analysts at Hotchkis & Wiley are organized by industry and support both our equity and income strategy. Average tenure at Hotchkis & Wiley is about 14+ years with the firm. There were no changes to the team in the second quarter, and we did have some rotation in our research associate program and we will have a new analyst join us by the time we speak on our next call. So with that, I'm going to turn the discussion over to Ray.

Ray Kennedy: Good afternoon everybody, and thank you once again for joining us. I'm going to start on Page 2 where we talk about performance for the quarter and I'll just go ahead. As you can tell the historical performance has been very strong. We're still going to wear a little bit of the 2015 performance for our three-year numbers but the numbers since then - and prior to that have been all very strong.

What has driven quarter attribution, second quarter attribution? Really when you turn to Page 3 you'll see that we underperformed by about 13 basis points for the quarter. Clearly we've outperformed for the year but this was largely just driven by the reversal in energy. Energy, we have a pretty large overweight in energy and while our bonds have done well they tended to lag in the quarter—they are overweight and it hurt us a bit for the quarter. There's—a lot of that's just driven by the widening in yields that have occurred between the energy and the non-energy sector in high yield. For the year, it's about 100 basis points wider and it's actually been as wide as about 150 and it's actually come back in just largely driven by the volatility that's occurred in the oil prices.

In terms of the other sector that detracted from performance, financial services, slightly; telecom, slightly, and because of Sprint; and retail, slightly, because of a holding we have in PetSmart, but again that has rebounded slightly. The positive contributors have been our healthcare and technology, as well as our core industrial bet which continues to outperform the market. So that's kind of reflective when you see on this page, that the energy tends to be in the CCC and in the non-rated portions of the portfolio. You'll also see the Credit Default Swap (CDX); we had a slight short on in the portfolio and that actually was a positive contributor.

So if you turn to Page 4, this talks about positioning, and again this reflects a little bit about the energy allocation that we talked about, which is we are significantly overweight. It's been a bit of a detractor this year, but only slightly and we still see a lot of opportunities there. Most of our positions tend to be senior in the capital structure and tend to be in Exploration and Production (E&P) credits that tend to focus on single fields, tend to have no maturity issues and tend to be dominated by bonds in the capital structure and we don't really have many concerns about the actual names even if there is more volatility within the sector.

The basic industry continues to just be a core part of our portfolio and of course our underweight that we've talked about many times - not owning the wireline in Sprint resulted in a natural underweight in the telecom sector. Interestingly enough, Sprint has had a pretty good year, so it's something we've slightly missed, but the other parts of the telecom sector, CenturyLink, Frontier, OneStream, those have really underperformed, especially Frontier in the last month or so. So net-net telecom has actually been a positive contributor to the portfolio.

An area that we are looking at more closely now is financial services. With the recent earnings out definitely shows some strength in that sector, so we're taking advantage of that and looking around for ideas.

In terms of the overweights, a lot of these names you're not going to know but it kind of highlights a bit of the strategy, which it tends to be a little bit of looking at off-the-run midcap names and most of these kind of fit that category. There is a few large cap names in there, like Navistar or Rainier, but for the most part they tend to be issuers and in kind of the midcap size of the high yield market.

Turning to Page 5, we get asked the question, 'so where are we in the high yield market?' We really about three months ago or so we were much more negatively disposed toward the high yield market. We have moved to kind of be a little bit more constructive, maybe a little more neutral despite having very tight valuations. A few things that are driving that; one is the growth overseas in Europe and China has basically helped improve the economic backdrop, the weakness of the U.S. dollar is really beneficial especially for the industrial part of our portfolio, the Fed is clearly dovish that we have to be—that we have to recognize that a mistake is possible, and historically we've seen in the markets where they tend to tighten too fast. Right now they seem to be taking a very slow, moderate approach, which is beneficial as a backdrop to the credit markets.

Fundamentals are okay in our market. We continue to see a little bit of improvement in leverage. We tend to see a bias toward reducing debt, companies issuing equities. So from that standpoint the fundamentals are holding in pretty well. Technicals have been really changing pretty fast. At the beginning of the year the technical backdrop was positive, we saw flows, but then we saw a new issue calendar step in which turned to be negative. Liquidity in the market has improved dramatically. Even with the headlines out there about the drop in trading, we're seeing pretty robust trading activity by dealers. In fact, their frustration is there's just not enough. The really interesting part about the technical backdrop as we speak is that the new issue calendar it looks like it's going to be significantly smaller in the second half and that could be very constructive toward high yield, especially as we see high demand by foreign buyers. The combination of a weak high yield calendar, high foreign demand for the asset class, could provide a lot of support for the second half of the year. So that's moved us to be a little bit more constructive on the asset class.

Things we're keeping a close eye out for, China, of course oil, politics, it doesn't seem like a day doesn't go by when we see some sort of volatility, as you can imagine, most healthcare stocks are up today and then the Fed. What I'd like to do—oh, we have a question.

Mary: Actually, before we head into the—dive in a little bit further on some of the market cycle stuff; High yield vs. the rest of the fixed income market it's been really a hot topic with a lot of our clients and our distribution partners. What are your feelings on some of the negativeness on the high yield space vs. some of the other areas of fixed income?

Ray: This past week there was an article about the risk-adjusted returns for high yield and I think the way we look at it is first of all the high yield market is not a uniform market. It basically goes from BB, B to CCC and I think a lot of us feel like the BB market is a little bit overbought right now. Being a little bit more overweight in single Bs is probably beneficial and probably has maybe a little bit more risk-adjusted returns. When we look at the overall credit markets, and I guess the proof is in the pudding by the foreign buyers, they'd rather see a kind of core high yield in their portfolios rather than investment grade where you're taking on more rate risk or even higher quality BBs where you're taking on more rate risk and high spread. If you believe the economic backdrop is supportive of high yield, then basically an allocation to high yield is justified.

The market that gives us a lot of concerns right now is the loan market. The loan market's in a total frenzy. There's just not enough paper. The collateralized loan obligation (CLO) market now represents about 65% of the loan market. We're seeing a lot of crazy stuff happen. Interestingly enough, a strong loan market probably provides a little bit more credit support for the high yield market because a lot of these loans are coming without covenants, which means that the financial risk of many of our issuers is being reduced. But no one can sit there and say with a straight face that credit is cheap, but you can say that parts of the credit market are okay value and that's the way we look at it.

Mary: We do have another question on energy. With the energy sector holdings, where are the breakeven points for oil prices and how much of the future revenues are hedged?

Ray: That's been kind of the challenge for high yield this year. Most of our issuers have hedged this year. So 2017 breaking below 40 probably isn't an issue. The basic way we all look at the breakevens now in high yield is 50 is probably where they're making good money or decent money; 40 they're getting an okay economic return; 30 they're probably breakeven or even losing a little bit of money; and if you break below 30 then you have problems.

And so that those are kind of the numbers to think about. Now let's put that in perspective. Where we were four years ago or three years ago where the breakeven was probably 50, 60 is where you kind of had a decent economic return, and 70 is where you really got your excess return on investment. So the breakevens have come down substantially, but in essence the core part of your question, which is for the rest of 2017, most of the issuers are pretty well hedged. It's really 2018 and from then on and - that's where our view is that we are going to see a little bit more balance occur in the market. It's already starting to occur. If you watch the Wednesday release on inventory, they clearly have come back in line as we saw earlier today, but it's going to continue to be a topical part of the high yield market. The high yield market so far has survived what I characterize as a pretty big widening in energy relative to the way it happened in 2014 when it first started and then of course in 2015. So we'll continue to watch this closely.

Mary: What factors are driving the improvement in liquidity if trading is down and how do the ETFs impact this?

Ray: Yes, the trading volumes are down largely because there's just less activity in the market but the ability to trade has actually increased quite a bit and we've seen that with dealer inventories have increased. My rationale for explaining this was when Dodd Frank was implemented, and it really was implemented really kind of 2014 when it really kicked in, it is was just an adjustment period for the banks to basically go to a non- proprietary trading book to a more regulated book approach. For example, we were meeting with a dealer last week and they pointed out that on new issues that if they hold any inventory more than 30 days they have to fill out about a five or six page document and send it off to the Fed. So think about the processes that had to be put in place with Dodd Frank. Once everyone's kind of figured them out and figured out how to trade in this new world, you saw liquidity pick up. Of course it's not as much driven by balance sheets anymore but it's clearly agency-driven, meaning that traders are taking the paper and selling it off, but as we spent our last week rounding through the various dealers they all said the same thing, which is they have no restraints on their ability to take inventory. In fact, they're being asked to take more inventory where they can. Their problem is just right now the market just needs probably more supply to basically create more trading activity. Last year of course trading activity was very, very good in the high yield market and I think they're wearing a little bit of year-over-year comps in terms of trying to support that.

Mary: Great. I think those are the questions on market outlook for now.

Ray: Okay. Well, great. So we're just going to go over a newsletter we put together. We try to cover topics that are a bit unusual or at least topical in the market and one of the themes that we keep hearing, which is, "Boy this feels a lot like 2007 and aren't we set up for a similar break in the high yield market?"

So let's start on Page 6, which is this shows the spread over treasuries and the reason we're going to show that is no doubt about it, we're at the tighter end of the high yield market. We are not at the tightest end of the high yield market. That was really kind of the 2004 to 2007 period or even kind of the mid-1990s, but we're definitely down there and so the concerns are justified.

If you turn to Page 7, one of the things we want to kind of point out though is that the distress ratios actually are still benign, default rates are still benign and they can be like that for long periods, but what's interesting about this chart, on Page 7, is that you see two default cycles. You have the 2002 and you have obviously the 2009 and if you recall the distress debt ratio is always going to be ahead of the actual default rate, which makes sense because stuff trades down before it actually defaults, but you look since then, we've had some mini kind of default cycles, as we saw with energy, then we saw it in metals and mining, and we saw it in the financial crisis. So technically since the last default cycle we've actually had three mini default cycles. So it's a little bit different market that we're seeing right now which is we're probably not going to witness a huge one big jump in defaults but we're going to probably watch a series of what we call rolling defaults through industries and the data is bearing that out.

So the point is that we have been going through some pickup in defaults relative to historical periods, they just tend to be—they're going to spread out kind of in these little rolling periods. The other thing is if you—but what really drives the high yield market and where we tend to see problems is when we see problems in the new issue market and you can kind of guess that. We create this natural vintage problem in the high yield market. It's been—ever since I've been involved with it, it has occurred, but if we look back in the '95, '98 periods where we saw a big pick up in the lower rated new issuance in the market, that was telecom and sure enough, if you look at the chart on the right, you saw the defaults pick up. In 2004 to 2007 we had the LBOs-the mega LBOs by the way, not just regular LBOs and of course, you know we're seeing the subsequent default that occurred to that. We don't have that problem. In fact, the lower rated issuance is almost at historical levels at a very low level, which means we're not building a vintage of problems that typically occur and that may be one of the reasons we're seeing this kind of rolling default rather than a big default.

The other thing on Page 9 is the PIKs. These are payment in kind, securities, zero coupons. Then we actually created something in the mid 2000s called toggles where the companies had the option to actually PIK if they wanted to, so they would toggle back and forth. You can definitely see, you know that it was actually very high in the previous two cycles and they tend to be very low now. The reason we point those out is that these are issued by companies that don't have earnings, and so the fact that we're not issuing it says that basically companies are only issuing debt where they can actually service their debt. PIKs are companies that are growing assets in the hopes of generating cash flow in the future. Classic case was a McLeod Telecom or something like that.

If you turn to Page 10, again, this just kind of says a little bit more about this whole issue of the vintage and kind of the use of proceeds that we've seen in the new issue calendar. The cap ex in the 1990 period and then of course the LBOs, we just don't have that issue. In fact, most of the issuance that we've seen in our market has been for refinancing, which means we've been pushing out the maturity walls, and so we don't really have any near-term maturity pressures in the high yield market. So we never want to say things are different this time but we definitely don't have the excesses that had been built in the past.

If you turn to Page 11, this talks a bit about cap ex. Cap ex tends to—when you see excess cap ex you tend to see overcapacity in markets developing. We just haven't had that in the last few years. In fact, that's probably been the mystery of this GDP growth cycle, which is, we just haven't been adding capacity because there's still a lot of excess capacity in the market. So we're not creating excesses and excesses are where you create problems.

Then finally, turning to Page 12, talking a little bit about the yield curve. I hope I'm going to say this correctly, but every recession has had an inverted yield curve but not every inverted yield curve environment has resulted in a recession but it's something we have to watch. So if you look around clearly we're watching the yield curve but so far the yield curve is behaving like it should in this environment and we're not going negative. Once we go negative we clearly—the red flag or at least a big yellow flag has to go up, but if we keep moving the way we're moving, which is kind of still keeping a little bit positive sloping, we're probably going to be at least putting off any problems in the near term in the high yield market.

So I encourage you to read the newsletter. It's something a little bit different again that we wanted to educate our investor base about. By the way, if you have some topics that you think would be interesting for us to cover, we'll be glad to do it. Our policy in the past has been it's not a marketing piece, it's not about us, it's about the market and what we see from our perspective and give you some commentary on it. So with that, we'll take additional questions, and I appreciate the time you've given us this afternoon and the support you've given Hotchkis & Wiley.

Mary: Great. Operator, we'll go ahead and queue up questions. While we wait for that, if anyone has chat questions, if they'd like to chat in we'll leave that option open as well. I'd just like to remind everyone that tomorrow Stan Majcher, who is our energy analyst, will be doing an overview of the energy sector across all of our strategies. So if that's something of interest, the information is posted out on our website or you can reach out to your Hotchkis & Wiley relationship manager for more information on the call.

Operator: We thank you, Mary. As a reminder, if you'd like to ask a question over the phone, it's star, one. A confirmation tone will indicate your line is in the question queue. You may press star, two if you would like to remove your question from the queue. Also, for participants using speaker equipment, it may be necessary to pick up your handset before pressing the star keys. One moment, please, while we poll for questions. Once again, that's star, one if you'd like to ask a question over the phone. It appears there's no questions over the phone. Did you have any closing comments?

Mary: No. Thank you Operator. We'll just go ahead and close out by saying thank you to everyone for joining us today and for your interest in the Hotchkis & Wiley high yield strategy. We hope you have a great day.

Ray: Thank you.

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

Returns shown for A and C Shares for the periods prior to their inception are derived from the historical performance of I Shares of the Fund during such periods and have been adjusted to reflect the higher total annual operating expenses of each specific Share class (Inception date: I Shares-3/31/09, A Shares-5/29/09, C Shares-12/31/12). Returns shown for A Shares and C Shares without sales charge do not reflect the maximum sales load of 3.75% or the Contingent Deferred Sales Charge (CDSC) of 1.00% for the first year; if reflected, performance would be lower than shown. Returns for A and C Shares reflect the deduction of the current maximum initial sales charges of 3.75% and 1.00% CDSC. C Shares convert automatically to A Shares approximately eight years after purchase. A Shares are subject to lower annual expenses than C Shares. I Shares sold to a limited group of investors. Periods over one year are average annual total return. Average annual total returns include reinvestment of dividends and capital gains. Expense limitations may have increased the Fund's total return.

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