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Hotchkis & Wiley
High Yield Webinar Replay

Hotchkis & Wiley

The High Yield Market: A Mid-Year Update

Listen in as Ray Kennedy discusses 2Q19 performance and portfolio positioning. Hear his outlook on High Yield markets for the remainder of the year.

Audio Replay **Presentation**

Hotchkis & Wiley High Yield Fund - Average Annual Returns as of June 30, 2019

	2Q19	1 Year	3 Year	5 Year	10 Year	Since 3/31/09
I Shares (net of fees)	1.71%	4.19%	6.83%	3.75%	8.96%	9.89%
I Shares (gross of fees)	1.89	4.94	7.58	4.49	9.73	10.66
ICE BofAML BB-B US HY Constr. Index	2.82	8.62	7.13	4.81	8.58	10.13
ICE BofAML US High Yield Index	2.56	7.58	7.54	4.70	9.22	11.23

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: 6.22%; 30-Day SEC Yield w/o Expense Waiver: 6.07%. *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 High Yield Call for Investment Professionals. At this time all participants are on a listen-only mode. If anyone should require operator assistance during the conference, please press *0 on your telephone keypad. As a reminder, this conference is being recorded. It is now my pleasure to introduce your host Mary Papamarkou. Thank you, Ms. Papamarkou, you may begin.

Mary Papamarkou: Thank you, operator. Good afternoon, and welcome to the Hotchkis & Wiley High Yield Strategy Call for Investment Professionals. My name is Mary Papamarkou, Managing Director, and I'm joined today by Ray Kennedy, Portfolio Manager. On behalf of everyone at Hotchkis & Wiley, thank you for joining us today. We will be conducting a half-year review of the portfolio performance and positioning, with a discussion on our outlook for the remainder of 2019. As the operator mentioned, 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 will do our best to answer as we go along.

Some key updates about our firm and the high yield strategy as of June 30th, 2019. Our firm assets totaled approximately $31 billion. The high yield strategy had approximately $4 billion in total assets, of which approximately $2.5 billion are in the fund, and the remainder in separate institutional accounts. Let's meet our High Yield team. There have been no changes to the team this quarter. And let's go ahead and get this webinar started.

Ray Kennedy: Good afternoon, everybody, and thank you for joining us on our quarterly call. I'm going to start on page three, or slide three, that begins with the title "Performance." This is our performance against the benchmark, and I'm not proud to say that we have not had necessarily a good last 12 months, and its kind of carried over a little bit from what we talked about in the previous quarter, which is the weakness in the energy market combined with, what I characterize as positioning that's off market where the current demand is. And I'll go into a little bit more detail on that on page four.

If you look on page four, this talks about attribution by rating, and this is probably a good way to look at what's been going on with the market. You are to start the year to be long duration and long high quality, and underweight single B's and triple C's. And you can see that that's basically how we've achieved underperformance in our portfolio.

Basically, we're a single B oriented manager and this segment of the market has significantly underperformed double-B's, combining, or compounding that is really the duration effect that occurs in double B's, which they tend to be about a half to one full year longer than most single B's. And that in itself, because of the rally in the 10-Year Treasury, has benefited double B's more than it has single B's, and of course, triple C's. So, that's looking at attribution by rate.

Mary: So, right. A core component of this strategy is small and mid-cap issuers. How has the volatility in that space impacted the portfolio, and what do you think might help it to reverse course? How are you approaching investing overall?

Ray: The story, as I mentioned, has been really a high quality, long duration focus in the high yield market. Left behind were the single B's and compounding that is really the smid, as we call the small and mid-cap names. This is something that many of the strategists have pointed out, that if you took the top 500 issues based upon size in the high yield market, they have massively out-performed the small issues in the market, by about 250 to 300 basis points alone. So, you can definitely see that focus.

Now, we've gone through periods of this in the past, generally it's about a quarter or two, and then it reverts. This is taking much longer, I think a lot of it's going to be driven by, or it has been driven by the flows coming into the market, I know we're going to talk a little bit more about that -- that have been driven largely toward the double B space. Again, just adding more pressure on the difference between double B's and single B's. Single B's tend to be more small and mid-cap issuers. We have not changed our strategy based upon that. Again, we've seen these patterns of dispersion before, between the large caps and the small caps, and we think that it will narrow some, if not all, at some point this year.

Mary: And then, are you still seeing investment-grade funds dip down into the higher end of your market?

Ray: That has been a constant theme, it seems like it's part of this credit cycle. It's been clearly a factor this year, but I would say that a lot of it's just been driven by the flow of funds into the high yield market, basically buying the double B space, and less so on the investment-grade side. Though they're clearly, with the Treasury rally, you did see a lot of investment-grade funds step into high yield to take advantage of the rally in the Treasury rate.

Mary: Great, thank you.

Ray: Now if you go to the next page, this talks about attribution by sector. Again, a few things to point out, this is by quarter, and again, you can see a few things. The basic industries and consumer goods, where we've had most of our underperformance, were two securities that had what we characterize as acts of God. One of them had a significant fire that shut a major piece of operating equipment at the company down significantly and those bonds were marked down. We do see that recovering, and so we're confident that we'll get a recovery of in performance of that situation.

The other one was impacted by tariffs as well as by bad weather. As we all know, the weather in the Midwest has been very challenging over the last few months with the heavy rain. And so anything tied to planting, agriculture, even the equipment that goes along with it, have been impacted, we've seen that as a secondary factor. Energy, we continue to have some issues to sort through there, and we're confident that we're starting to see bottom in this space. But it may be a long recovery versus the 2015-2016 sell-off that we saw in energy that tended to snap back. As a strategy for us, in energy, we have been shrinking that. It's been happening naturally through some attrition in performance but also in the form of some asset sales that we had in the portfolio. So we expect to see the weight in that come down significantly.

Turning to page six, this talks about portfolio positioning. We characterize as being a mid-oriented manager, we tend to be kind of an industrial portfolio, and you'll see the overweights reflect that. And the names that we tend to be overweight, are your basic widget manufacturers, or a basic chemical company, or a paper manufacturer, not necessarily commodity-oriented papers, and you've seen that allocation. We are also overweight automotive, because we do see value there. I think the market probably punished that space a little bit too much, because of the weakness in car sales. So far the sales have not come in at the levels that people were worried about.

On the other side, our underweight continues to be the telecom sector, we've talked a lot about that. Banking and finance, we'd love to add more, it's just a valuation question. And I sound like a broken record, I think I've mentioned that multiple times. And then you know, in terms of things like media and utility, we can tell you we’ve looked for opportunities, in fact we've added some utility space this quarter. Telecom and wire--the telecom sector is broken down into the satellites and wire lines space. Wire lines has turned out to be a good idea because given the turmoil that's been happening there with Windstream's bankruptcy in the beginning of the year. Some are talking about Frontier potentially restructuring, so we continue to avoid that space.

When you look on the right side of the slide, you'll see some—in terms of carry, we continue to have pretty attractive carry, with a higher coupon rate, which is something that will benefit us if the market just kind of goes sideways for a while.

And conversely, we have a lower dollar price, a little bit higher spread over Treasuries. Our triple C exposure has been kind of flat; it's actually come down over the last few years. And my guess is we'll continue to see it drip down a little bit. In terms of the duration, this is the comment I was making earlier, which is being a single B-oriented manager, our duration tends to be slightly lower than the overall market, where the double B's tend to have higher duration. And so, when you do see a rally in Treasuries, we will tend to not benefit from that rally.

Mary: And so, Ray, before we move on, given the impending T-Mobile/Sprint merger, do you think we would reevaluate our long term underweight to telecom?

Ray: It's going to be a challenge for the high yield market to sort through how we're supposed to manage a potentially $50 to $75 billion issuer in the high yield market, representing anywhere, depending upon what index or what rules are going to apply, 4-8% of the overall high yield market, or of the specific index.

Our index is capped at 2%, and we will admit, a combined T-Mobile/Sprint is an attractive credit, and there's certain bonds that clearly would make sense to add. And so, our expectation is that if the valuation looks wide to the market, we would add exposure there. But we'll continue to reevaluate that. But given the overall weight in the high yield market, it will be interesting to see how investors manage through that. Most high yield investors don't like to own position sizes of you know, three, four, five percent in an individual issuer.

Mary: Great, thank you. And then on the other side of the page here, bank loans continue to move up in the portfolio. Are you taking advantage of the sell-off in the dedicated bank loan fund asset class? I think bank loans through June 30th are $3.3 billion in outflows, and the worst selling asset class year to date.

Ray: Correct. Yeah, when we saw that, being a value-focused manager, especially in this smid space, we found some attractive opportunities there that are structurally senior and looked attractive. And so we've been adding those opportunistically in the portfolio, especially ones that potentially are in cyclical areas where we are hesitant to basically add a lot of--a long term exposure, or a lot of long duration exposure, or unsecured exposure.

So, you know, they continue to pay off at high rates. I think our low was about 3-4%, we're about 6% now. My guess is we'll probably going to hover here for a while. If we do see a stabilization by the Fed, we may see that flow reverse. I think I started talking about this about a year ago, that the bank debt market was kind of poised for a sell-off, and that has clearly occurred, especially in the small middle market space, or in the private-lending space.

Mary: Great.

Ray: Next page just talks about performance and I'm happy to say, continue to see over time that the strategy has been additive to our investors. And we continue to thank you for your support, and we look forward to things improving over the next 12 months or so. And I know, that's where we're going to head now, which is talking about the outlooks of the high yield market. We've always been using this chart of fundamentals, technicals, and valuations, in terms of discussing the overall high yield market.

Let's just go left to right. In terms of fundamentals, defaults continue to be relatively modest in the high yield market. Interestingly enough, we are seeing a pretty consistent number of defaults and restructurings going on in the energy space. We've avoided most of them so far, but they tend to be smaller issuers, especially in the bank debt area, but we're talking about issuers in the 500-million-size space. Outside of that, with the exception of Hexion, there hasn't been really a large bankruptcy, and we don't really see one out there.

In terms of the actual financial statistics that we're witnessing, first quarter earnings for most high yield issuers, they were weak, and we're expecting the same this quarter. But there clearly has been a focus by management teams to de-lever, so they've been able to withstand this. We've had probably the highest number of calls and tenders out of our portfolio this past year. A lot of it's been done through asset sales, or basically using other markets like equity to take things down. I think a lot of that's driven by the legacy of the tax law that went into effect that does punish companies for having excessive leverage.

But you know, we continue to watch the revenues and earnings, and I think it's going to be more of a second-half story. And I think the equity markets are clearly, being a forward-looking-driven market, they tend to think that the second half is where we're actually see the improvement in earnings. The one gray area is the trade, and the impact that that's been having on issuers. It happens in strange ways. It's not necessary a direct relationship, meaning you sell into China, or you somehow have a tie to China. Sometimes it's a supply issue that can basically impact it. But you know overall it's mixed, but we'd probably assign it to three.

The real story in high yield has basically been technical. So flows have been strong this year, and they continue to come in, and that's clearly buoyed the market. The new-issue market has been okay, but it's still weaker than it has been past years. But it's higher than it was last year, but last year was a pretty weak year. But as I mentioned with the number of calls and tenders going on, which means your portfolio's constantly low on cash, combined with the high flows, continues to be a technical tailwind that will continue to support the asset class. So it really comes down to valuation.

Just to put things in perspective, we started the year at 8%, and we're now inside 6% in the high yield market. But you know, with the Treasury, the 10-Year Treasury hovering around 2%, I guess it's not surprising. It's 400 off, for spreads, you tend to basically be kind of near historical averages so long as the fundamentals are okay, we'll probably continue to see a decent support for the asset class for the rest of the year, which means, you know, for investors, coupon-like type returns, but as we've cautioned in the past, we tend to see air pockets, especially come around earnings season or in the Fall when tend to see a historical volatility pick up. So we probably will continue to see better entry points for buying bonds.

Mary: So, you've referenced several times the high yield flows, and that they've been strong this year. Where have they been going?

Ray: In almost all cases, the ETFs have been buying the long duration double B paper. And, which scares us from a standpoint that if there's a reversal in flows, you could definitely see that sector get beaten up pretty hard. But that's definitely been the flow. When they run out of ideas, then they start stepping down. I think the reason you're seeing that type of behavior is because a lot of the investors who are subject to those flows are worried that they're temporary and could reverse. And since we're long in the credit cycle, they're a little bit more hesitant to take on more core credit risks.

Mary: And then, so you've mentioned a few things; the trade war drama, the ETF reversal potentially. Are there other things from the current market environment perspective that keep you up at night?

Ray: Well, we always talk about bank debt, but also the other credit asset classes that are out there that we have less visibility on. The Fed is clearly focused on bank debt, and the liquidity situation there. And while that does not directly impact us, it does reprice our market. And so, those are the types of things we've been focused on. The CLO market, which continues to boost the bank debt market, represents about 65% of that. The bank debt market continues to be pretty robust, so there doesn't seem to be a crack there. But you know, it's always the unknown out there that concerns you, and clearly the tariff one is probably front and center for all of us.

Mary: Great. And with that, we'll finish out our call today. Thank you for your interest in the Hotchkis & Wiley High Yield Strategy, and for participating on today's webinar. Have a great day.

Operator: Ladies and gentlemen, this does conclude today's webinar. Thank you for your participation. You may disconnect your lines at this time, and have a wonderful day.

This material must be preceded or accompanied by a current prospectus.

Mutual fund investing involves risk. Principal loss is possible. Investments in debt securities typically decrease in value when interest rates rise. This risk is usually greater for longer-term debt securities. Investment by the fund in lower-rated and non-rated securities presents a greater risk of loss to principal and interest than higher-rated securities. The Fund may invest in derivative securities, which derive their performance from the performance of an underlying asset, index, interest rate or currency exchange rate. Derivatives can be volatile and involve various types and degrees of risks. Depending on the characteristics of the particular derivative, it could become illiquid. Investment in Asset Backed and Mortgage Backed Securities include additional risks that investors should be aware of such as credit risk, prepayment risk, possible illiquidity and default, as well as increased susceptibility to adverse economic developments. The Fund may invest in foreign as well as emerging markets which involve greater volatility and political, economic and currency risks and differences in accounting methods.

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Top ten holdings as of June 30, 2019 as a % of the Fund's net assets: HCA Inc. 1.3%, American Zinc Recycling 1.2%, General Electric Co. 1.1%, Ashton Woods USA LLC 0.9%, Shelf Drilling Hldgs Ltd. 0.9%, Qorvo Inc. 0.9%, Townsquare Media Inc. 0.9%, Weekley Homes LP 0.9%, Rayonier A.M. Products Inc. 0.9% and GasLog Ltd. 0.9%. Fund holdings are subject to change and are not recommendations to buy or sell any security.

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