Top Reasons to Invest in High Yield in 2017

Newsletter – December 2016

"If you don't know where you're going, you might wind up someplace else"

-Yogi Berra (1925 - 2015)

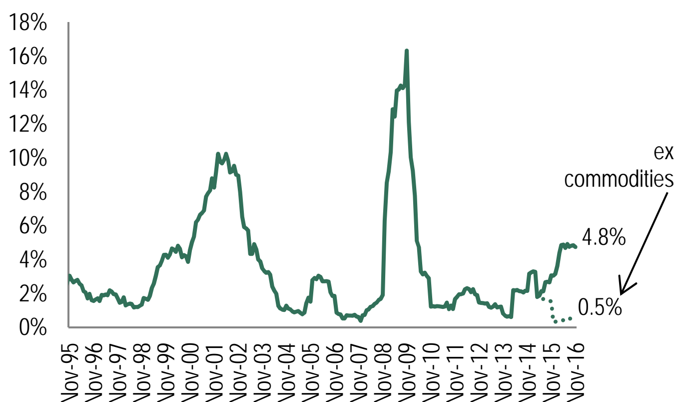
The good news is that the high yield market has returned more than +15% in 2016, as of the end of November. The bad news is that valuations are now more extended as we look forward. The high yield market's median spread over treasuries for the past 30 years is about 500 basis points. At the beginning of 2016 the spread was 695 basis points; as of November 30, 2016 the spread was 467 basis points. Thus, spreads have narrowed from a starting point considerably wider than average to an ending point slightly tighter than average. The spread narrowing has tempered our near-term return expectations compared to a year ago, but as we look forward the high yield asset class continues to possess attractive characteristics that we believe should benefit investors; our latest newsletter highlights eight of the most compelling. The first four reasons describe why today is a good time to invest in high yield; the last four represent reasons why high yield should have a permanent allocation in a diversified portfolio.

I. Reasons today is a good time for high yield

#1: Default rate is poised to retreat

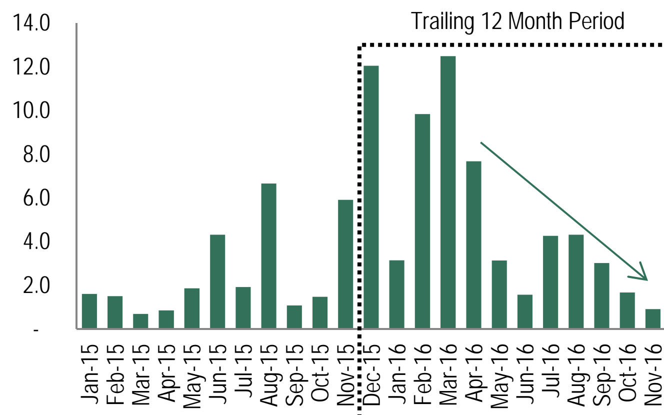
The historical default rate is shown in Chart 1a. The default rate as of November 30 is 4.8%, which is mostly due to commodity company defaults triggered by the fall in oil prices over the past couple years.

Chart 1a: Default Rate
Trailing 12 months, includes distressed exchanges



The default rate has remained rather stable in recent months, which is deceptive because defaults have declined significantly. The reason for this apparent paradox is that the default rate is customarily quoted as a trailing 12 month figure. Chart 1b shows actual defaults in dollars each month since the beginning of 2015. The boxed area represents the trailing 12 month period as of November 30. As each month passes, the box will shift to the right and the default rate will begin to exclude some of the months that experienced significant defaults. The key takeaway is not the illusory nature of default rate calculations but that defaults appear to have peaked, which has cleansed the market of the weakest credits.

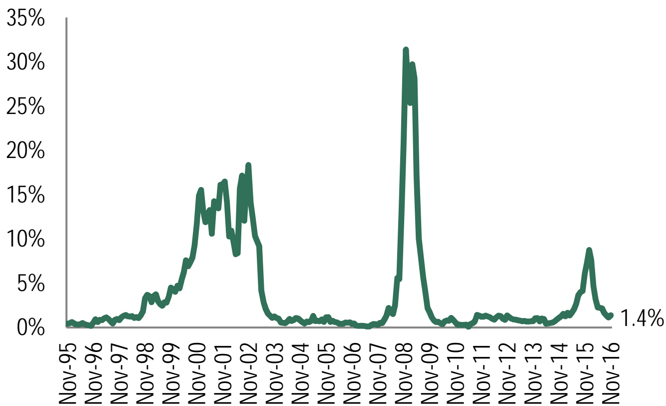
Chart 1b: HY Defaults Month by Month
$billions of par value, includes distressed exchanges



As shown in Chart 1c, only 1.4% of the high yield market is currently considered distressed debt, down from 8.7% early in 2016. Distressed debt is defined as credits trading for 50% of par value or less, and represents a reasonable proxy for the market's expectation of future defaults. Current prices suggest the market believes defaults will remain benign; we are inclined to agree.

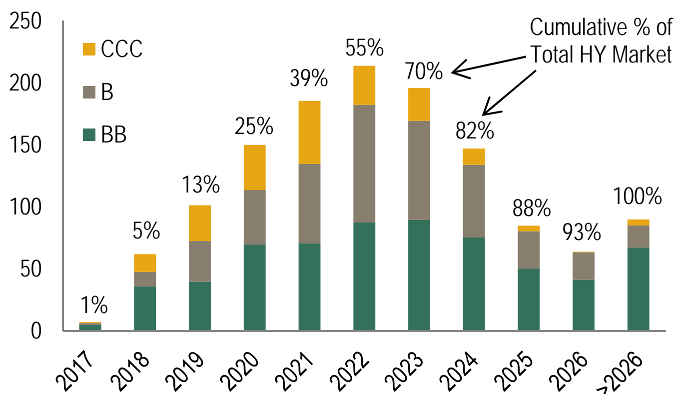
Past performance is not a guarantee or a reliable indicator of future results.

Chart 1c: Distressed Debt as % of Total Market
Distressed debt = trading at 50% of par or less



Another factor supporting a benign default environment going forward is the high yield maturity schedule, as depicted in Chart 1d. Time is on the side of the borrower as near term refinancing requirements are manageable. The market is termed out quite evenly as a result of unprecedented refinancing over the last several years.

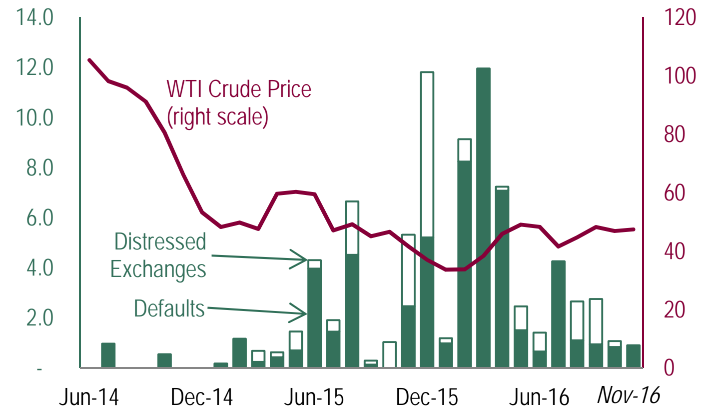
Chart 1d: HY Maturity Schedule
As of 11/30/16, in $billions of par value



#2: Commodity problem has largely played out

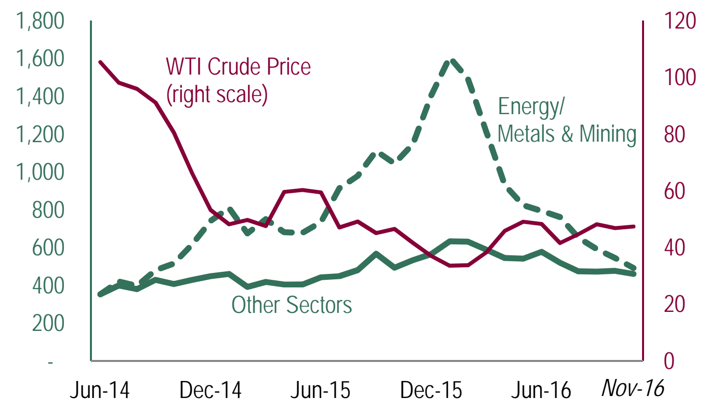
Commodity-related credit defaults appear to have peaked, which is why we believe defaults will remain subdued. Chart 2a shows monthly defaults for credits in the energy and metals & mining sectors. Since peaking early in the year, defaults and distressed exchanges have moderated.

Chart 2a: Energy/Metals & Mining Defaults by Month
Par value in $billion



As shown in Chart 2b, spreads for commodity credits have narrowed as quickly as they widened, and are now almost at parity with the rest of the market.

Chart 2b: Energy/Metals & Mining Spread Over Treasuries
Basis Points



#3: New issuance has been disciplined

A flood of low quality new issues can increase the overall risk profile of the market. From 2004 to 2008, for example, about one out of every four new issues carried a CCC rating (red bars in Chart 3). By the end of 2008, 23% of the market was rated CCC or below. In contrast, only one out of every ten new issues thus far in 2016 carried a CCC rating, and just 14% of the market is rated CCC or below. The lack of LBO activity is partially to blame but investors simply appear more cautious.

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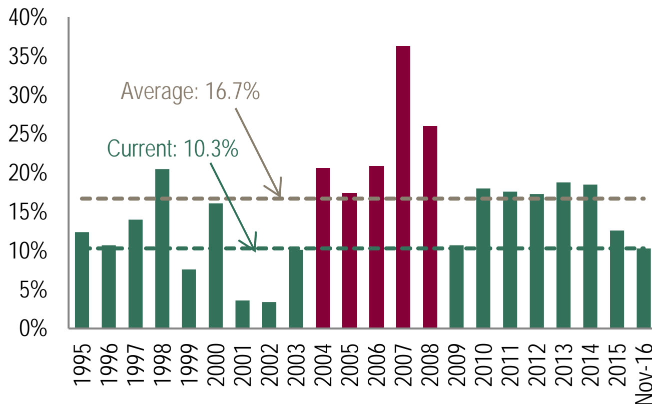
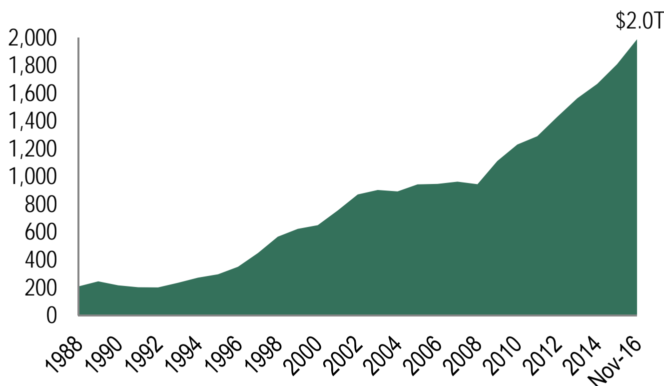
Chart 3: CCC rated new issuance
As a percentage of total new issuance



#4: Liquidity has improved

The public market for high yield credit has become a critical funding source for US businesses. As shown in Chart 4a, the total size of the high yield market now stands at $2.0 trillion, up more than 100% since the financial crisis. For perspective, the size of the 200 year-old US stock market is slightly less than $20 trillion; hence, the high yield market is now more than 10% the size of the stock market. High yield is no longer the "also" asset class; it has become a core allocation for institutional investors.

Chart 4a: High Yield Market Size
$billions



In the capital markets, size and liquidity are positively correlated. Accordingly, high yield market liquidity has improved as the market has grown. Charts 4b and 4c show liquidity by average dollars traded and average number of bonds traded, respectively. Both depict a market that has become increasing liquid in recent years, especially as the market adjusts to a post Dodd-Frank world.

Chart 4b: Average Daily Volume of HY Market
$billions

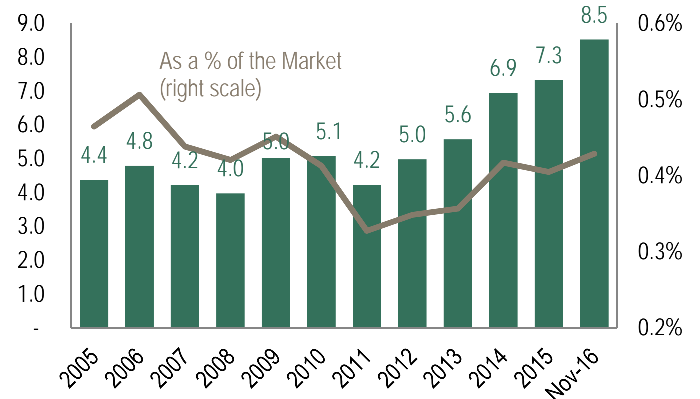
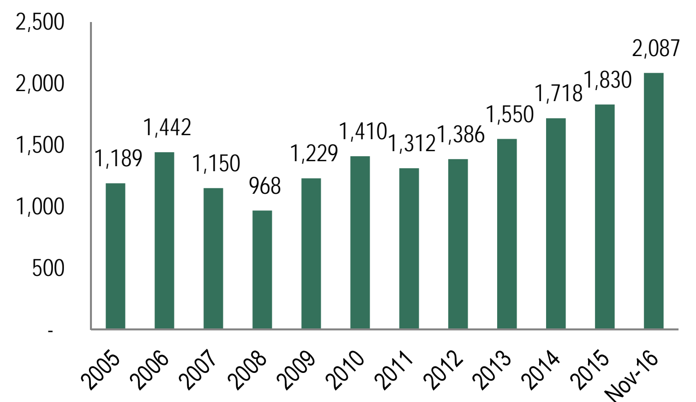


Chart 4c: Average Number of Bonds Traded Per Day



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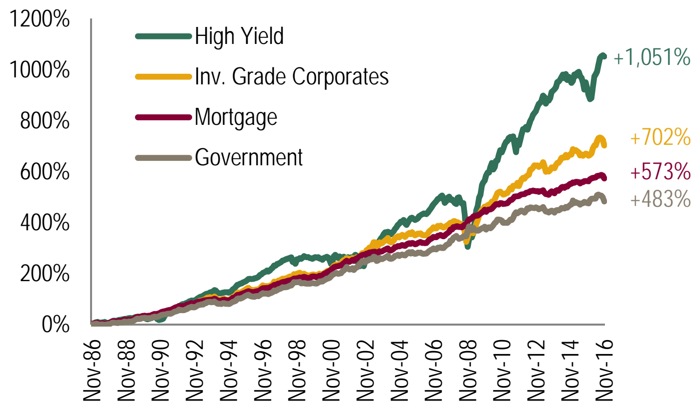
III. Reasons HY belongs in a portfolio long term

#5: Long-term performance

Chart 5 shows the cumulative performance for various broad fixed income categories going back to 1986, the inception of the high yield index. A $10,000 hypothetical investment in high yield would be worth over $115K today, compared to $80K for investment grade corporates, $67K for mortgage-backed bonds, and $58K for government bonds[1].

Chart 5: Cumulative Performance
9/30/86 – 11/30/16

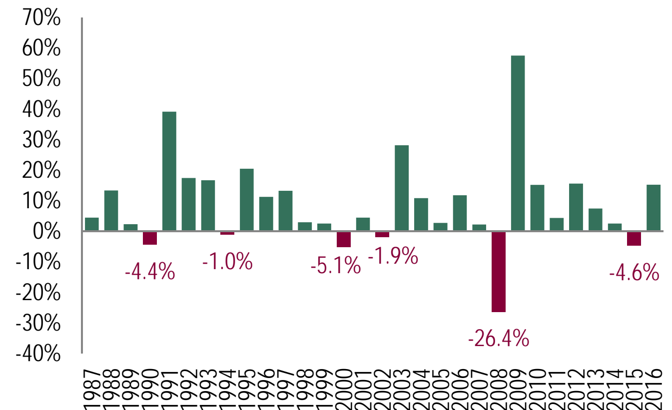


#6: Negative years have been rare and modest

Of the last 30 calendar years, the high yield market rose in 24 and fell in 6, a 4 to 1 ratio. Of the 6 calendar years that the market declined, 5 were of modest magnitudes, ranging from -1.0% to -5.1%. The only year of significant decline was 2008 when the market returned -26.4%. The following year, in 2009, the high yield market returned an impressive +57.5%. This does not guarantee consistency going forward, but we have found that many people are surprised by the dearth of large negative declines historically for a "risky" asset class. Remember, coupons represent 75% of the total return of high yield over long periods.

[1]Growth of $10,000 since 9/30/86 reflects a hypothetical $10,000 investment in the indexes noted and assumes reinvestment of dividends and capital gains. Performance data quoted represents past performance; past performance does not guarantee future results. Index performance is not illustrative of fund performance. One cannot invest directly in an index. Please call 800-796-5606 for fund performance.

Chart 6: High Yield Calendar Year Performance
As of 11/30/16

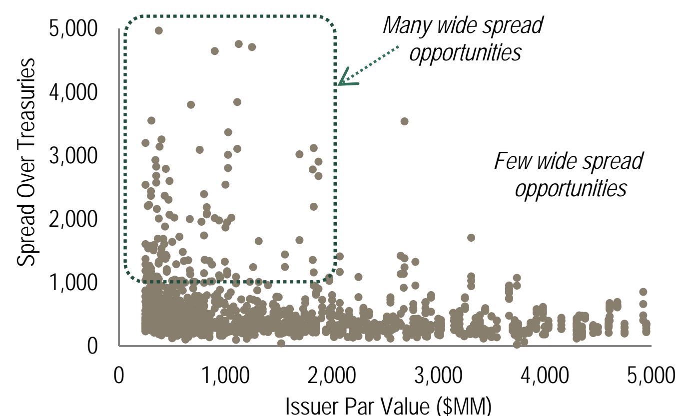


#7: Broad opportunity set for nimble active managers

In aggregate, the valuation of the high yield market is reasonable for the risks at hand in our view—neither overly compelling nor overextended. Not all bonds are created equal; however, and individual opportunities exist for diligent credit pickers. Many of these opportunities exist in the form of small and mid cap credits, as shown in Chart 7. Many of the largest high yield asset managers, however, including ETFs, are compelled to overlook this attractive market segment. They are unable to take meaningful positions without assuming undue liquidity risk because of excessive assets under management. Managers committed to remaining nimble are able to access this highly inefficient portion of the market and improve the risk/return profile of their portfolio.

Note: Our previous newsletter explored the small and mid cap credit market in detail. If you would like a copy, please request one from your Hotchkis & Wiley client service representative.

Chart 7: Spreads by Issuer Size
As of 11/30/16, in basis points



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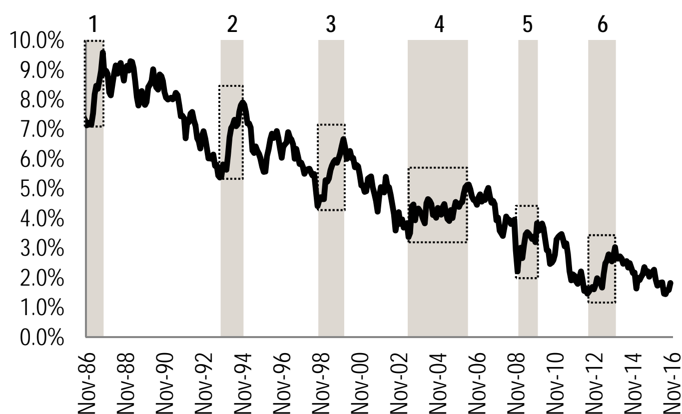
#8: Performance during rising rates

Interest rates have been in a secular decline over the last 30 years. Chart 8 highlights six intermittent periods when rates rose, however, and the table below highlights the performance of the high yield market during those periods. The high yield market's median annualized return in those periods was +8.1% and returns were positive in all six periods. Because high yield bonds are more tied to the credit cycle than to the interest rate cycle, they have performed reasonably well when rates rise.

Chart 8: 10-Year Treasury Yield



	Date			10-Yr Treas Yield			Ann Perf	
	Beg	End	#Months	Beg	End	Change	10 Yr Tr	HY
1	Aug-86	Sep-87	13	6.9%	9.6%	2.7%	-8.9%	6.9%
2	Sep-93	Nov-94	14	5.4%	7.9%	2.5%	-8.8%	1.2%
3	Sep-98	Jan-00	16	4.4%	6.7%	2.2%	-7.7%	3.7%
4	May-03	May-06	37	3.4%	5.1%	1.7%	-0.5%	9.3%
5	Dec-08	Dec-09	12	2.2%	3.8%	1.6%	-9.8%	57.5%
6	Jul-12	Dec-13	17	1.5%	3.0%	1.6%	-6.2%	9.5%
						Median	-8.3%	8.1%

Average annual total returns for one, five and ten-year periods ended 11/30/16: (10 Yr Tr) Barclays 10-Year US Treasury Bellwethers Index: -0.08%, 1.86%, and 4.76%; (HY) BofA Merrill Lynch U.S. High Yield Index: 12.25%, 7.46%, and 7.25%.

Summary

Despite average valuations for the broad high yield market, we continue to identify compelling reasons for high yield investors to be optimistic. As we look to 2017 and beyond, we believe defaults should moderate as the commodity credit cleansing has largely played out. The quality of the new issue market has been high and liquidity in the market has improved. These are all factors that should bode well for high yield investors. In addition to these favorable near/medium term factors, the high yield market possesses long term attributes that should also benefit investors. Historically, high yield has limited correlation with other asset classes[2] and has outperformed other fixed income asset classes, which can improve a portfolio's volatility/return profile; significant negative return years have been rare; and nimble active managers can exploit a highly inefficient market segment where opportunities abound. Finally, the asset class has performed well during previous periods of rising interest rates, which seems to be a probable path as we look forward. We view the long-term risk-return profile of the asset class as compelling, particularly for bottom-up credit pickers willing to roll up their sleeves.

Hotchkis & Wiley High Yield Research

[2]0.58 vs. S&P 500 Index, 0.54 vs. MSCI EAFE Index, -0.09 vs. Barclays 10-Year US Treasury Bellwethers Index, -0.06 vs. Barclays 3-Month US Treasury Bellwethers Index, based on the period of 9/30/86 – 9/30/16.

Past performance is not a guarantee or reliable indicator of future results. Index performance is not indicative of fund performance. An investment cannot be made directly in an index. To obtain fund performance please visit www.hwcm.com or call 800-796-5606.

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All investments contain risk and may lose value. 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.

Any data or reference to the "High Yield Market" refers to the BofA Merrill Lynch US High Yield index.

Charts 1a-c, 3 & 4a: JPMorgan; Chart 1d: BofAML, Goldman Sachs, Bloomberg; Chart 2a: JPMorgan, Bloomberg; Charts 2b, 5-7: BofAML, Bloomberg / Indices used: HY - BofA Merrill Lynch US High Yield index, Investment Grade Corporates - BofA Merrill Lynch US Corporate Index, Mortgage - BofA Merrill Lynch US Mortgage Backed Securities Index and Government - BofA Merrill Lynch US Treasury & Agency Index; Charts 4b-c: FINRA TRACE, Bloomberg; and Chart 8: Barclays, Bloomberg, BofAML. **Diversification does not assure a profit or protect against loss in a declining market.**

The BofA Merrill Lynch US High Yield Index tracks the performance of below investment grade, but not in default, US dollar-denominated corporate bonds publicly issued in the US domestic market, and includes issues with a credit rating of BBB or below, as rated by Moody's and S&P. The BofA Merrill Lynch US Corporate Index tracks the performance of US dollar denominated investment grade corporate debt publicly issued in the US domestic market, the BofA Merrill Lynch US Mortgage Backed Securities Index tracks the performance of US-dollar-denominated 30-year, 15-year and balloon pass-through mortgage securities having at least $150 million outstanding per generic production year, the BofA Merrill Lynch US Treasury & Agency Index tracks the performance of US dollar denominated US Treasury and non-subordinated US agency debt issued in the US domestic market, the S&P 500 Index is a broad based unmanaged index of 500 stocks, which is widely recognized as representative of the equity market in general, the MSCI EAFE (Europe, Australasia, Far East) Index is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. & Canada, the Barclays 10-Year US Treasury Bellwethers Index represents the US 10 year Treasury Bill, and the Barclays 3-Month US Treasury Bellwethers Index represents the US 3 month Treasury Bill. The indices do not reflect the payment of transaction costs, fees and expenses associated with an investment in the Fund. It is not possible to invest directly in an index.

Basis point is a unit that is equal to 1/100th of 1% and is used to denote the change in a financial instrument. LBO stands for leveraged buyout. (WTI) stands for West Texas Intermediate crude. Par value is the face value of a bond. Spread is the percentage point difference between yields of various classes of bonds compared to treasury bonds. Spread over Treasuries is the difference in yield between a fixed-income security and a Treasury security of similar maturity. Volatility is a statistical measure of the dispersion of returns for a given security or market index.

Credit Quality weights by rating were derived from the highest bond rating as determined by S&P, Moody's or Fitch. Bond ratings are grades given to bonds that indicate their credit quality as determined by private independent rating services such as Standard & Poor's, Moody's and Fitch. These firms evaluate a bond issuer's financial strength, or its ability to pay a bond's principal and interest in a timely fashion. Ratings are expressed as letters ranging from 'AAA', which is the highest grade, to 'D', which is the lowest grade. In limited situations when none of the three rating agencies have issued a formal rating, the Advisor will classify the security as nonrated.

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You should consider the Fund's investment objectives, risks, and charges and expenses carefully before you invest. This and other important information is contained in the Fund's summary prospectus and prospectus, which can be obtained by calling 800-796-5606 or visiting our website at www.hwcm.com.

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